NCUA

NATIONAL CREDIT UNION ADMINISTRATION

NEWARK PUBLIC LIBRARY
SEP 11 1986
U. S. GOVT. PUBS.
DEPOSITORY 378

# EXAMINER'S GUIDE

## Part 1

October 1986

## Foreword

The Examiner's Guide is a tool to be used by National Credit Union Administration staff in accomplishing the mission of the Agency. It is a source of information on NCUA policies and on the operations of credit unions. It provides a standard for efficiently supervising and evaluating the performance of credit unions and examiners. It is a method of providing uniformity and continuity in the supervision of credit unions. It is also a training aid to be used by the staff.

The Guide is divided into various Chapters of major importance. Each Chapter is divided into sections. Two Chapters, Examination and Supervision, have tabs to separate the sections. Each Chapter has an index outlining the major areas of discussion (sections and subsections). Copies of appropriate workpapers are included in Section 19 to provide easy reference. Additionally, some Chapters and sections include sample letters, reports and miscellaneous information.

The Guide provides the examiner with guidance in completing examinations of and providing supervision to credit unions; it is only a guide. The examiner should become familiar with its contents and have a working knowledge of the forms contained in it. In that way the examiner can use its contents in the most effective and efficient manner, adjusting examination and supervision procedures to fit the situation. The examiner should explain significant deviations from the guidelines.

Throughout the Guide, examiners are directed to focus their attention on "material" facts, differences, items or amounts. For guidance the following general rule may be applied.

> A statement, fact, practice or item is material if it is of such a nature that its disclosure or treatment would be likely to influence or to "make a difference" in the judgment and conduct of a reasonable person. The accumulation of many small items would be "material" if the cumulative effect would tend to influence the judgment and conduct of a reasonable person.

In general any decision, policy or practice which adversely impairs the dividend paying ability of a credit union should be considered material. Major violations of laws, regulations or internal controls also should be considered material because of their potential impact on operations.

This edition of the Examiner's Guide supersedes the February 1982 edition of the guide, including Changes 1-6.

Roger W. Jepsen

ROGER W. JEPSEN
Chairman
National Credit Union Administration Board

# EXAMINER'S GUIDE

## 1. Examination Objectives

The Examination Chapter is designed to aid the examiner in planning and conducting examinations. Procedures have been developed to give the examiner latitude in performing a meaningful examination while meeting essential examination objectives. The objectives are to:

(1) Evaluate the credit union's financial soundness;

(2) Appraise the quality of management;

(3) Develop plans with officials to correct areas of weaknesses; and

(4) Determine the degree of risk to the National Credit Union Share Insurance Fund (NCUSIF).

Required workpapers have been kept to a minimum, but optional workpapers may be used to support conclusions and recommendations.

### 1.1 Core Examination

The core examination concentrates the examiner's initial review of credit union activities on key trends and ratios and key management and operational areas. The core examination is intended to best use NCUA's resources while ensuring the safety and soundness of credit unions. Thus, while enabling the examiner to expand the scope of an examination when problem areas are detected, examiner time will be minimized in well-managed credit unions.

### 1.2 Expanding Examination Procedures

Core examination procedures are designed to readily detect material problems and/or potential problems in the most efficient manner. By analyzing key trends and ratios and responding to the Examination Overview, the examiner should be able to determine if additional examination steps are warranted.

In a well-operated credit union, the examiner's analysis generally will cease with the completion of the core examination procedures. Only in unusual circumstances will additional examination procedures be performed where problems or potential problems are not evident. In these unusual circumstances, reasons for the expansion of the examination procedures should be explained in NCUA 2141, Closed Section.

Examiners should be alerted to existing and evolving problems through the core examination procedures. When these problems are noted, the examiner should expand the analysis to the extent and the depth necessary to determine the causes of, and possible solutions to, the problems. When uncertain if a problem actually exists or is developing, the analysis should be expanded until the examiner is comfortable with the findings.

The core examination is designed to lead the examiner to major problems and/or potential problems. Generally, a major problem is one that directly relates to a credit union's safety and soundness and, if unresolved, could eventually threaten its viability. The examiner should not spend significant time looking for minor problems. Problems of a minor or a technical nature should be brought to the officials' attention verbally or included in the Examiner's Findings, NCUA 2115. Minor problems should not be included in Records of Action unless the officials consistently fail to make corrections.

The responsibility for determining when to expand examination procedures beyond the core examination lies with the examiner. Often it is a decision which is based solely upon the examiner's experience and ability. In some instances, i.e., complex situations, the examiner may wish to consult with the Supervisory Examiner.

## 1.3 Workpapers

The core examination is supported by the use of several mandatory workpapers. When the core examination is expanded, the examiner may use any optional workpaper described in other sections or Chapters of the Guide of examiner-designed workpapers in analyzing a problem area. Examiner-designed workpapers should be logical and readable to others. Those core examination workpapers so designated below will be left with the officials in the Supervisory Examination Report folder. Useful copies of operation or examiner-designed workpapers also may be left.

Core examination workpapers include:

| | | | Guide Reference |
|---|---|---|---|
| | (1) | NCUA 2010, Examination Input | Exam 18.2 |
| | (2) | NCUA 2013, Consumer Compliance Checklist | Exam 15 |
| * | (3) | NCUA 2020, Supervisory Examination Report (folder) | Exam 18.3 |
| * | (4) | NCUA 2030, Examination Overview | Exam 18.4 |
| * | (5) | NCUA 2035, Record of Action (if applicable) | Exam 18.5 |
| | (6) | NCUA 2045, Examination Financial Data | Exam 16.2 |
| * | (7) | NCUA 2046, Key Ratios | Exam 16.3 |
| | (8) | NCUA 2047, Asset Share Ratios (if applicable) | Exam 16.3-8 |
| * | (9) | A Statement of Financial Condition, either the credit union's or, when that is materially inaccurate, NCUA 2050, Statement of Financial Condition | Exam 3 |
| * | (10) | A Statement of Income, either the credit union's or, when that is materially inaccurate, NCUA 2051, Statement of Income | Exam 5.1 |
| | (11) | NCUA 2055, Examination Scope | Exam 1.4 |
| * | (12) | NCUA 2110, Collection Problem | Exam 8.1-1,<br>8.6-3 |
| * | (13) | NCUA 2115, Examiner's Findings (if applicable) | Exam 18.7 |
| * | (14) | NCUA 2120, Loan Exceptions (if applicable) | Exam 8.9 |
| | (15) | NCUA 2141, Closed Section (if applicable) | Exam 18.8 |
| | (16) | NCUA 2170, Examination Information | Exam 2.1-1 |

| | | |
|---|---|---|
| (17) | NCUA 2255, Loan Data Sheet | Exam 8.2 |
| (18) | NCUA 2390, Investment Internal Controls | Exam 9.0 |
| (19) | NCUA 2435, Currency and Foreign Transactions Letter | Exam 15.4 |

* **Distributed to officials**

Instructions for assembling the report are contained in Section 18

### 1.4 Examination Scope, NCUA 2055

NCUA 2055, Examination Scope, is an internal NCUA workpaper which will be completed during each examination and included with the field copy of the examination report.

The workpaper is designed to assist the examiner is determining that all major areas are reviewed. All applicable areas listed on the Examination Scope should be tested or reviewed to determine if there are material problems in the area. When the initial review of an area indicates there are no serious problems, analysis of the area can be quite minimal. The level of analysis will depend on the complexity of operations and the seriousness of adverse conditions.

Examiners have the flexibility to expand the scope of the examination as conditions warrant. Examiners should consider previously reported weaknesses, extent and quality of the supervisory committee's audit work, and current conditions in determining the scope of the examination. When major areas of concern are encountered, the analysis will be expanded to allow development of reasonable and effective plans for corrective action.

There is no one correct order or sequence for completing examination scope procedures. Review of the supervisory committee audit and completion of NCUA 2045, Examination Financial Data, and NCUA 2046, Key Ratios, should be early in the examination to the extent possible. These forms and review of the audit will be helpful in determining the scope of the examination. Examiners should adjust the sequence of procedures to most efficiently examine the credit union.

Each section of the Examination Chapter refers to appropriate scope procedures. The examiner should become familiar with the interrelationships of the scope and the Guide.

### 1.5 Other Core Examination Workpapers

Instructions for completing other workpapers used in performing the core examination are discussed in other sections of the Examination Chapter of this Guide.

### 1.6 Workpapers and References

(1) Workpapers

  a. NCUA 2055, Examination Scope.

# EXAMINER'S GUIDE

## EXAMINATIONS

## TABLE OF CONTENTS

Page

### 1. Examination Objectives

1.1 Core Examination 1
1.2 Expanding Examination Procedures 1
1.3 Workpapers 2
1.4 Examination Scope, NCUA 2055 3
1.5 Other Core Examination Workpapers 4
1.6 Workpapers and References 4

### 2. Pre-Examination Planning

2.1 Scheduling Examinations 1
2.1-1 Examination Information, NCUA 2170 1
2.2 Initial Examinations 1
2.3 Pre-Examination Review 2
2.3-1 Branch Offices 2
2.4 Team Examinations 3
2.4-1 Advance Team Contact 3
2.4-2 Pre- and Post-Examination Conferences 4
2.5 Workpapers and References 4

### 3. General Ledger

3.1 Financial and Statistical Report, NCUA 5300 2
3.2 Receivables, 720 Series 3
3.2-1 CLF Stock, 750 Series 3
3.2-2 Prepaids, 760 Series 3
3.2-3 Fixed Assets, 770 Series 3
3.2-4 Accruals, 780 Series 4
3.2-5 Other Assets, 790 Series 5
3.2-6 Accounts Payable, 800 Series 5
3.2-7 Notes Payable, 810 Series 5
3.2-8 Dividends Payable, 820 Series 6
3.2-9 Interest Refunds Payable, 830 Series 6
3.2-10 Taxes Payable, 840 Series 6
3.2-11 Accrued Expenses, 850 Series 6
3.2-12 Other Liabilities, 860 Series 6
3.2-13 Exceptions, 870 Series 6
3.2-14 Deferred Credits, 880 Series 6
3.3 Contingent Liabilities 7
3.4 Valuation of Balance Sheet Accounts 8
3.5 Individual Share and Loan Ledgers 8
3.5-1 Ledgers Out of Balance 8
3.5-2 Arbitrary Adjustments 9
3.6 Records Seriously in Arrears or General Ledger Out of Balance 9

3.7 Material Contracts 10
3.8 Pension Plans 10
3.8-1 Accounting for Pension Cost 11
3.9 Workpapers and References 12

**4. Reserves**

4.1 Reserves and Undivided Earnings, NCUA 2220 1
4.1-1 Regular Reserve 1
4.1-2 Undivided Earnings 2
4.2 Allowance for Loan Losses, NCUA 2210 3
4.3 Value of Retained Earnings 4
4.4 Workpapers and References 4

**5. Profitability**

5.1 Statement of Income, NCUA 2051 1
5.1-1 Pro Forma Estimations 2
5.2 Analysis of Profitability 3
5.3 Extended Analysis of Profitability 3
5.3-1 Yield on Assets 5
5.3-1.1 Yield on Loans 5
5.3-1.2 Yield on Investments 5
5.3-1.3 Yield on Major Assets 5
5.3-2 Operating Expenses to Assets 6
5.3-3 Cost of Funds to Assets 6
5.3-3.1 Cost of Shares 6
5.3-3.2 Cost of Borrowed Money 6
5.3-4 Net Income (Loss) After Dividends to Assets 6
5.3-5 Net Income (Loss) from Operations to Assets 6
5.4 Workpapers and References 7

**6. Funds Management**

6.1 Liquidity 1
6.2 Brokered Shares/Funds 2
6.3 Loan Turnover Rate 3
6.4 Regular Shares/Share Drafts 4
6.5 Matching Rate Sensitive Assets and Liabilities 4
6.6 Cumulative Total Percentage 4
6.7 Liquidity Measure 5
6.8 Policies 5
6.9 Balance Sheet Structure 6
6.10 Conclusions and Recommendations 8
6.11 Workpapers and References 10

**7. Management**

7.1 Management, NCUA 2130 1
7.2 Board Minutes, NCUA 2230 2
7.2-1 Membership Meetings 2
7.3 Financial Management 3

7.4 Personnel and Operational Management 3
7.5 Surety Bond Review 4
7.6 Summary 4
7.7 Workpapers and References 5

**8. Loan Analysis**

8.1 Examination Procedures 1
8.1-1 Loss Ratio 2
8.2 Loan Policies 3
8.3 Approval and Lending 5
8.3-1 Credit Reports 5
8.4 Individual Loans 6
8.4-1 Random Sample Procedures 6
8.4-2 Loan Profile, NCUA 2270 7
8.5 Loan Types 8
8.5-1 Large Loans and Concentrations 8
8.5-2 Insiders' Loans 9
8.5-3 Lines of Credit 9
8.5-4 Open End Loan Plans 11
8.5-5 Commercial Loans 12
8.5-5.1 Commercial Loan Policies/Practices 14
8.5-6 Mortgage Loans 17
8.5-6.1 Home Equity Loans 19
8.5-7 Floor Plan Loans 20
8.5-8 Participation Loans 21
8.5-9 Insured - Guaranteed Loans 21
8.5-10 Balloon Notes 22
8.5-11 SBA Loans 23
8.5-12 Variable Rate Loans 24
8.5-13 Construction Loans 26
8.6 Allowance for Loan Losses 30
8.6-1 Simplified Classification 31
8.6-2 Individual Classification 32
8.6-3 Collection Problem Loans, NCUA 2110 34
8.6-4 Collection Procedures 35
8.6-5 Charge-Off of Collection Problem Loans 37
8.7 Collateral In Process of Liquidation 38
8.8 Purchased Loans 38
8.8-1 NCUA Guaranteed Loans 39
8.9 Loan Exceptions, NCUA 2120 39
8.9-1 Illegal Loans 40
8.10 Bankruptcy 41
8.11 Workpapers and References 50
Table of Random Digits
Sample Credit Report

**9. Investment Analysis**

9.1 Policies 1
9.2 Audit 4
9.3 Safekeeping 4

9.4 Records 5
9.5 Investment Valuation 6
9.5-1 U.S. Government Obligations 7
9.5-2 Federal Agency Securities 7
9.5-2.1 Ginnie Maes 8
9.5-2.2 SBA Guaranteed Loans 9
9.5-3 Mutual Funds/Common Trusts 10
9.5-4 Credit Union Service Organizations (CUSO) 10
9.5-4.1 Legal Limitations 10
9.5-4.2 Examination Procedures 11
9.5-4.3 Examination of a Credit Union Service Organization 11
9.5-4.4 Federally Insured State-Chartered Credit Union Involved in Credit Union Service Organizations 11
9.5-5 Federal Funds 12
9.5-6 Corporate Central Credit Unions 12
9.5-7 Other Credit Unions 13
9.5-8 Other Shares, Deposits and Certificates 13
9.5-9 Loans to Other Credit Unions 16
9.5-10 Allowance for Losses on Investments 16
9.5-11 State and Municipal Obligations 16
9.5-12 Repurchase Transactions 16
9.6 Commitments to Purchase/Sell Securities 17
9.7 Reverse Repurchase Transactions 19
9.8 Purchase/Sales Analysis 20
9.9 Illegal Investments 21
9.10 Workpapers and References 21
9.11 Glossary of Investment Terms 23
Sample Bailment Agreement of Securities

**10. Share Structure**

10.1 Share Management 1
10.2 Cost of Shares 2
10.3 Share Account Types 3
10.3-1 Regular Type Shares 3
10.3-2 Share Drafts 4
10.3-2.1 Examination Procedures 4
10.3-2.2 Operational Flow 4
10.3-2.3 Sound Operation 5
10.3-2.4 Overdrafts 5
10.3-2.5 Verification 7
10.3-2.6 Settlement Accounts 7
10.3-2.7 Cashing Drafts 7
10.3-2.8 Fees 8
10.3-2.9 Internal Accounts 8
10.3-3 Share Certificates 8
10.3-4 Money Market Accounts 9
10.3-5 Individual Retirement Accounts 10
10.3-5.1 Types of Individual Retirement Accounts 10
10.3-5.2 Contributions 10
10.3-5.3 Tax Exemptions 11

10.3-5.4 Annual Reports 11
10.3-5.5 Credit Union Employees' Retirement Plans 11
10.3-5.6 401K Plan 12
10.3-6 Organizational Accounts 12
10.3-7 Escrow Accounts 12
10.3-8 Nonmember Accounts 13
10.3-9 Public Unit Accounts 13
10.3-9.1 Treasury Tax and Loan Accounts 13
10.3-9.2 Depository and U.S. Agent Account 15
10.3-10 Brokered Funds 16
10.4 Advertising and Disclosures 16
10.5 Workpapers and References 16

**11. Cash Analysis**

11.1 Examination Procedures 1
11.2 Bank Reconcilements 2
11.3 Credit Balance in Cash Account 2
11.4 Money Orders/Travelers' Checks 3
11.5 Food Stamps/Savings Bonds 3
11.6 Treasurer's Drafts 4
11.6-1 Treasurer's Draft Activity 4
11.6-2 Examination Procedures 4
11.6-3 Official Checks 4
11.7 Federal Reserve's Payment System Risk Program 5
11.8 Workpapers and References 7

**12. Internal Controls**

12.1 Appraisal 1
12.2 Definition 2
12.3 Basic Elements 2
12.4 Recommendations 6
12.5 Conflict of Interest and Insider Dealings 6
12.6 Workpapers and References 8

**13. Supervisory Committee**

13.1 Examination Procedures 1
13.2 Initial Meeting 1
13.3 Workpaper Access 2
13.4 Standards 3
13.5 Auditors 3
13.6 Rating Criteria 4
13.7 Workpapers and References 4

**14. Electronic Data Processing**

14.1 Definitions 2
14.2 User Controls 3
14.2-1 Management Controls 4
14.2-2 Operational Controls 5

14.2-3 Internal Controls 6
14.2-4 Data Communications 7
14.2-5 Backup 9
14.3 Audit 9
14.4 Records 10
14.5 Contracts 11
14.6 Workpapers and References 12

## 15. Regulation Compliance

15.1 Charter and Bylaws 1
15.2 Security Devices 1
15.3 Records Preservation 2
15.4 Currency and Foreign Transactions 2
15.5 Share Insurance 3
15.6 Operating Fees 3
15.7 CLF Stock Subscriptions 3
15.8 Transaction Account Reserves 3
15.9 Margin Securities 4
15.10 Political Contributions 5
15.11 Consumer Laws and Regulations 5
15.11-1 General Guidance 6
15.11-2 Reviewed Forms Listing 6
15.11-3 Compliance Review Procedures 6
15.11-3.1 Truth-in-Lending (Regulation Z) 6
15.11-3.2 Equal Credit Opportunity (Regulation B) 10
15.11-3.3 Electronic Fund Transfers (Regulation E) 12
15.11-3.4 Real Estate Settlement Procedures Act (HUD Regulation X) 13
15.11-3.5 Other Laws and Regulations 14
15.11-3.6 Other NCUA Laws and Regulations 15
15.12 Internal Revenue Service Reporting Requirements 15
15.13 Workpapers and References 16
Appendix - Explanations to the Consumer Compliance Checklist
NCUA/WO Reviewed Forms List

## 16. Conclusions - Total Analysis Process

16.1 Total Analysis 1
16.1-1 Data Analysis 2
16.1-2 Six Steps of Total Analysis 2
16.1-3 Four Levels of Analysis 4
16.1-4 Testing the Results 7
16.2 Examination Financial Date, NCUA 2045 7
16.3 Key Ratios, NCUA 2046 8
16.3-1 Market Growth Ratio 8
16.3-2 Loans to Assets Ratio 9
16.3-3 Loan Losses Ratio 10
16.3-4 Delinquent Loan Ratio 10
16.3-5 Retained Earnings Change Ratio 11

16.3-6 Capital Ratio 11
16.3-7 Net Worth Ratio 12
16.3-8 Personnel Expenses Ratio 12
16.3-9 Yield on Assets 12
16.3-10 Cost of Funds to Assets Ratio 13
16.3-11 Operating Expenses to Assets Ratio 13
16.3-12 Net Income (Loss) After Dividends to Assets Ratio 14
16.3-13 Net Income (Loss) From Operations to Assets Ratio 14
16.3-14 Optional Ratios 16
16.3-15 Ratio Analysis 16
16.4 Communicating the Results 16
16.5 Workpapers and References 16

**17. Joint Conference**

17.1 Optional Joint Conference 1
17.2 Conference Objectives 1
17.3 Agenda 2
17.4 Pre-Joint Conference Preparation 3
17.5 Conducting the Joint Conference 3
17.6 Other Persons Present 4

**18. Supervisory Examination Report**

18.1 Components 1
18.1-1 Assembly 2
18.2 Examiner Contact Information, NCUA 2010 2
18.3 Supervisory Examination Report (folder), NCUA 2020 3
18.4 Examination Overview, NCUA 2030 3
18.5 Record of Action, NCUA 2035 3
18.6 Supplementary Facts, NCUA 2036 4
18.7 Examiner's Findings, NCUA 2115 5
18.8 Closed Section, NCUA 2141 5
18.8-1 Recommendations 6
18.9 Workpapers and References 7

**19. Examination Workpapers and Forms Listing**

## 2. Pre-Examination Planning

Planning for an examination must commence before beginning the work at the credit union office and must be continuous throughout the examination.

### 2.1 Scheduling Examinations

The NCUA Board has established an Agency goal of reducing the examination cycle to allow for the annual examination of every Federal credit union. Therefore, the District Examiner is responsible for determining that every credit union in the district is examined annually. The fiscal year (October 1 to September 30) is the basis for an annual examination cycle.

Scheduling examination priorities is an ongoing responsibility of the examiner. The following factors should be considered when scheduling examinations:

(1) Financial conditions and trends in the credit union. The examiner may use prior examination reports, Financial Performance Reports, semiannual NCUA 5300s, credit union financial reports, and information received directly from the regional office or the credit union.

(2) Potential risk to the National Credit Union Share Insurance Fund.

(3) Date of last examination. Normally, examinations will not be conducted sooner than 8 months from the previous examination. Newly chartered credit unions will be examined in approximately 4 months from the charter date.

(4) Regional policy.

### 2.1-1 Examination Information, NCUA 2170

Examination Information, NCUA 2170, is a tool to assist examiners in scheduling examinations. As such, examiners should not feel bound to complete every block on the form and should include other relevant information even if no block exists.

### 2.2 Initial Examinations

Shortly after the charter date, the District Examiner should contact the officials to determine when operations commenced or if assistance is needed. The initial examination should be made within the first few months of operation to help the officials. Even if only modest activity has transpired, an examination should be scheduled.

The initial examination will be primarily focused on educating the new officials and ensuring that the credit union gets off to a good start. Close contact with officials should be maintained between the initial and the second examination. This is best done by requesting that monthly financial reports be sent directly to the examiner. Quarterly contacts by telephone are also beneficial. The first years of operation are critical to the success of the credit union. Examiners should provide necessary assistance during this period.

## 2.3 Pre-Examination Review

The Examiner-in-charge should ensure that certain steps are completed prior to beginning the examination. The purpose of the pre-examination review is to ensure the most effective use of examiner time during the examination. Prior to beginning the examination, the examiner should:

(1) Review the field file to determine the severity and persistency of previous problems and to determine if a Preliminary Warning Letter or an administrative action is outstanding against the credit union. As a minimum, the previous examination report should be reviewed.

(2) Determine the extent of the credit union's operations. A credit union that has large diverse investments, credit card loans, and long-term real estate loans may need a larger examination team than a credit union which does not have such programs.

(3) Review file correspondence. An explanation should be provided on the status of outstanding correspondence.

(4) Determine if advance notice is needed. The lead time for advance notice will depend upon the circumstances which prompted the advance notice.

(5) For team jobs, notify the team members of location, time, security precautions, length of examination, and other pertinent information. In this regard, the Examiner-in-charge will generally want to offer to make travel and accommodation arrangements for out-of-town team members who may be unfamiliar with the area.

(6) Make the initial contact at the credit union. Key officials should be informed of the examination, its probable duration, and the likelihood of a joint conference at the conclusion of the examination. The examiner should review current financial statements, compute key ratios, and discuss general economic conditions at the credit union with the treasurer or themanager during the initial hours of the examination.

### 2.3-1 Branch Offices

Branch offices will not usually be visited during examinations. Case-by-case exceptions to this policy can be made if:

(1) A full service branch is a material part of the credit union's overall operations;

(2) The examiner believes that a meaningful examination cannot be conducted without a review of the branch's operations (usually because of known or suspected material problems at the branch; and

(3) The Supervisory Examiner concurs that a branch review is necessary.

A full service branch has a teller operation, permanent personnel, and/or maintains its own loan files. This definition is very broad; examiners will have to exercise judgement when determining if a branch is full service or merely a minor extension of the main office. Very carefully applied judgement is also necessary to determine if a full service branch has a material impact on operations and if a branch visit is needed to conduct a meaningful examination.

In some instances, a large branch office may be located in another region. If it is determined that examination of such a branch is necessary, the two regions involved should coordinate the branch office examination. Usually, it will be cost effective to use examiners located in the proximity of the branch office rather than have examiners travel long distances to a branch office.

### 2.4 Team Examinations

A team examination requires more than one examiner in order to assure timely completion. Team examinations can be scheduled by the District Examiner after conferring with the Supervisory Examiner. The Examiner-in-charge's primary responsibility on a large team job is to coordinate, monitor, and facilitate the smooth completion of the examination.

### 2.4-1 Advance Team Contact

If needed, the Examiner-in-charge and selected team members should begin the examination before the full team arrives unless travel and time considerations preclude such an advance team contact. Substantial examination time can be lost during the initial phases of the examination while waiting for the credit union's employees to pull loan files or run special programs on the credit union's computer.

The following steps should be completed by the advance team prior to the arrival of the full team:

(1) Contact key officials to inform them of the examination, its probable duration, and the likelihood of a joint conference at the conclusion of the examination.

(2) Obtain working space for the team.

(3) Obtain the supervisory committee work and arrange to meet with the auditor(s).

(4) Obtain all board policies, including those related to loans, shares, investments, and funds management.

(5) If necessary, select the loans to be reviewed. Since the Examiner-in-charge usually will request that credit union employees pull the loan files, it is important to given them as much time as possible prior to the arrival of the full team. Whenever possible, and if needed, the examiner should request that the manager develop a program to select and print every "nth" loan. If this approach is used, the sample should be verified by checking back to the trial balance of the individual ledgers. At least five loans on a random sample and two loans on a selected sample should be verified manually by ensuring that the selected loans are within the established pattern.

(6) Scan board, executive, investment, etc., committee minutes.

(7) Allocate work assignments to team members. All workpapers, policies, and any instruction should be put together for the examiner who will be in charge of that phase of the examination. The Examiner-in-charge will then be free to coordinate and direct the overall examination more effectively.

### 2.4-2 Pre- and Post-Examination Conferences

The Examiner-in-charge will often find that pre- and post-examination conferences are desirable with either the full team or selected team members.

The pre-examination conference can be used to delegate areas of responsibility to team members, provide instructions on communicating with personnel at the credit union and, in general, plan the work.

The post-examination conference can be especially valuable in the more complex examinations in which the Examiner-in-charge may not have had the opportunity to become acquainted with all phases of the credit union's operations to get a briefing on such areas and to receive reports from the examiners at the credit union. The decision to hold pre- or post-examination conferences is that of the Examiner-in-charge. All time associated with the examination of the credit union, including team conference time, should be charged to the appropriate examination time Work Classification Code.

### 2.5 Workpapers and References

(1) Workpapers

  a. NCUA 2170, Examination Information

(2) References

  a. NCUA 1101, Definitions of Work Classification Codes

## 3. General Ledger

The review of a credit union's General Ledger and its related subsidiary ledgers should give the examiner a clear impression of the credit union's financial position and its relative financial stability.

The General Ledger is reviewed to determine that:

(1) Policies, practices, procedures, and internal controls regarding assets and liabilities are adequate;

(2) Credit union personnel are operating in conformance with established guidelines;

(3) The validity and the quality of material assets are evaluated;

(4) Liabilities are properly recorded;

(5) The credit union is in compliance with the Act, Rules and Regulations, and the Accounting Manual; and

(6) Corrective action is initiated when policies, practices, procedures, or internal controls are deficient or when violations have been noted.

An analysis of a General Ledger account should include: a determination that the account is in balance with the total of its subsidiary ledgers, a historical review of the debits and credits to analyze any unusual activity, and a general determination of the propriety of the entries. If it is determined that the General Ledger accounts are materially inaccurate, the examiner may footnote the credit union's financial statements or may use NCUA forms 2050 and 2051, Statement of Financial Condition and Statement of Income, respectively, to support the analyses. In some instances, the examiner may choose to use NCUA 2095, Trial Balance, to supplement the use of NCUA forms 2050 and 2051. Likewise, the examiner may wish to use the optional NCUA 2105, Subsidiary Ledgers, when a material out-of-balance condition exists between a subsidiary ledger and its General Ledger account.

In general, the examiner will not attempt to balance subsidiary ledgers to their control accounts. Instead, the examiner should determine why the account is out of balance or unreconciled and bring the problem to the attention of the operating personnel and/or the board of directors. Except in unusual circumstances, the examiner should not audit or verify individual entries in either subsidiary ledgers or in control accounts. It is the treasurer's responsibility to maintain accurate and current records. The supervisory committee has the responsibility to audit those records.

The depth of review for each General Ledger account that is not discussed in other sections of the Guide (Cash, Investments, Shares, etc.) will vary from one General Ledger account to another within a credit union and from one credit union to another. The most critical element in determining the degree of variance and the depth of review is the examiner's professional judgement and experience. Guidelines for review are:

(1) Materiality - for general guidance, the examiner should consider the following factors in determining the materiality of General Ledger accounts other than for those accounts specifically discussed elsewhere:

(a) Total Assets

Under 1/4 of 1% of total assets - generally immaterial

Over 1/2 of 1% of total assets - generally material

(b) Retained Earnings

Materiality can be affected by the credit union's ability to absorb potential losses. For example, a General Ledger account that represents 1/2 of 1% of total assets in a credit union with a very strong retained earnings position may be immaterial. Conversely, a General Ledger account under 1/4 of 1% of total assets for a credit union with a weak retained earnings position may be considered material.

(c) Profitability

In assessing the materiality of a General Ledger account, the examiner should also consider its impact on the credit union's profitability. In some instances, the impact on the balance sheet may be minimal, while the impact on the income statement may be material. Overstated accrued income, for example, may have little or no effect on the balance sheet but mean the difference between a negative or positive bottom line on the income statement. General ledger accounts directly affecting the income statement should be analyzed with emphasis placed on its impact (materiality) on the income statement (profitability).

(2) Unusual Activity - Activity which in the examiner's judgement is improper or which might adversely affect the credit union.

(3) Examination Period Activity - The examiner should be concerned primarily with activity during the examination period. For example, if the credit union purchased its building in a prior examination period, and if the account was reviewed during the last examination, a complete analysis is not necessary. It should only be necessary to determine the current fixed asset position of the credit union and that the earning assets can support the non-earning assets.

(4) Supervisory Committee Audit - A complete, professional audit may assist the examiner in reviewing the General Ledger accounts. Generally, the more recent an audit the more useful to the examiner. The examiner may include copies of an auditor's workpapers when they will add to the report or when they may be useful to the next examiner.

## 3.1 Financial and Statistical Report, NCUA 5300

The examiner will review the most recent semiannual Financial and Statistical Report, NCUA 5300, for accuracy. If material errors or omissions are discovered, the officials will be informed and appropriate instructions given to assure proper completion in the future. If material errors are discovered either by the examiners or the officials, the corrections should be sent to the regional or Washington office (according to regional policy) for input through the data correction process. The corrections will be submitted in accordance with the instructions in the most recent Data Correction Bulletin.

### 3.2 Receivables, 720 Series

Accounts receivable are generally funds due the credit union from persons other than members. Receivables could include payroll deductions, insurance premiums, taxes, etc. If a credit union has material accounts receivable, the examiner should determine that subsidiary ledgers are reconciled, that the receivables have been audited, and that the credit union receives payments on schedule. Receivables that will not be cleared will result in charges to an expense account and, as such, could affect the financial stability of the credit union.

### 3.2-1 CLF Stock, 750 Series

When a credit union is a direct member of the CLF (has membership stock recorded in General Ledger account 751), the examiner will audit the CLF Stock Subscription computation. If either an overpayment or an underpayment is found, the examiner will notify the CLF via the CLF's 800 telephone number.

### 3.2-2 Prepaids, 760 Series

Prepaid and deferred expenses are expenses that have been paid but which have not been fully utilized. Common examples include office supplies, prepaid fidelity/bond insurance, and prepaid league dues. These items are paid for a full year so that, at any point prior to year-end, the credit union has some value left, i.e., in June, there would be six (6) months' value remaining. The key to these expenses is that they must be for a coming period not for a prior period. The examiner should determine that the accounts have been, or will be, audited to ensure that items are not "hidden" to conceal an expense problem. Unless there are material amounts involved, the examiner will usually limit the review to the propriety of the entries in these accounts.

### 3.2-3 Fixed Assets, 770 Series

Fixed assets include three major categories of items owned or leased by the credit union: land and buildings, furniture and equipment, and leasehold improvements. All three categories are often material, as credit union owned data processing systems are recorded as furniture and equipment; and, for many governmental type credit unions, leasehold improvements include the complete construction of an office in a government-owned building. Land and buildings are almost always material items.

Prior to investing in major fixed assets, the board of directors should analyze carefully the need for the asset and its impact on the earnings ability of the credit union. The earning assets (loans and investments) must be able to support the building, computer, and major improvements made in the facilities. The investment in assets should be approved and recorded properly, and depreciation schedules should be established in line with Accounting Manual guidelines. The analysis of how the earnings position may be affected is discussed in subsequent Guide sections.

The examiner should also determine the credit union's compliance with Part 701.36 of the NCUA Rules and Regulations as it relates to the purchase of fixed assets. This regulation is particularly relevant to Federal credit unions with $1,000,000 or more in total assets.

On occasion, the examiner may be called on by the Regional Office to review a credit union's Request for Waiver in Fixed Assets in Excess of 5% of Assets. When reviewing the Request, the examiner must consider and document the following elements:

a. Impact on profitability
b. Impact on funds management and liquidity
c. Local economic factors which affect or may affect the credit union
d. Evaluation of space, usage, location, and method of financing the asset purchased
e. Projected balance sheets and statements of income and expenses, and those assumptions used in making the projections including supporting data where appropriate

An on-site contact by the examiner could be necessary to fully evaluate the credit union's request for the fixed asset waiver and to make a specific recommendation for approval/rejection to the Regional Director.

### 3.2-4 Accruals, 780 Series

Accrued income is income that has been earned but which has not been received. Common examples include Accrued Interest on Loans and Accrued Income on Investments. Loans and many investments earn income from the day the asset is established; however, that income may not be received for a month, in the case of loans, to 3 months or more in the case of many investments. Many smaller credit unions may not receive credit for earned income until bank passbooks are updated at the end of the year. Accruing the income as it is earned allows for a more accurate determination of the credit union's financial position at any point in time. Data processors usually provide the amount of unpaid but earned interest on loans to the credit union on a monthly report. Credit unions using such recordkeeping systems should be encouraged to adopt accrual accounting methods.

When a credit union adopts accrual accounting during the examination period, the examiner should determine that the accounts were established properly. The Accounting Manual, Section 4000, outlines the correct accounts and journal entries to record accrued income. The accruals should also be verified for accuracy. Depending on the complexity of the credit union's operations, the examiner should review and analyze the schedules used in calculating the accrued income on loans or investments. Section 4000 of the Accounting Manual also provides instructions in manually computing accrued income on loans.

If the credit unions is on a manual accounting system, it may be practical for the examiner to test the accuracy of the accrued income from loans by reviewing the repayment pattern in the journal and cash record. Payroll deduction is frequently the primary method of loan repayment by members in many credit unions. Therefore, by utilizing the interest on loans information in the journal, the examiner can prorate the recorded loan income for payroll deduction amounts to determine the estimated accrued income for the month. A line-by-line review of the journal and cash record should be made to insure that all payroll deduction amounts (weekly, bi-weekly, monthly) are recorded in the examiner's workpaper. In the case of bi-weekly payroll deduction, the last payroll check amount received will be recorded and the interest prorated. Since interest earned on loan payments involving cash are relatively small compared to payroll deductions, the examiner can "back into" that amount by taking the difference between loan income recorded for payroll deduction and the total income on loans reported for the month in the journal and cash record. This difference would then be divided by two (2) to arrive at the estimated accrual for cash loan payments. The combined estimated accrual would then be compared to that reported by the credit union.

If the estimated accruals are generated, the examiner should, if possible, verify its accuracy through sampling. Some automated accounting systems, for example, have the capability of generating a detailed list by account number for the accrued income on loans. A determination should also be made that interest is not being accrued on loans six or more months delinquent (Reference Section 2000 of the Accounting Manual).

If the examiner's estimate is not close to the recorded accrual, the analysis should be expanded to determine how the credit union arrived at its figures and the credit union's policies and practices for the accrual of interest on the delinquent loans. When assessing the materiality of the inaccuracies identified in the accruals, the examiner should also consider its impact on the credit union's reported income. A credit union's profitability can be materially affected by either an under or overstatement in the estimated accrual.

### 3.2-5 Other Assets, 790 Series

This "catch-all" account series includes equity in a credit union service organization, deposits with public utilities, non-sufficient funds checks, and, more recently, the Share Insurance Capitalization Deposit. In general, the examiner should determine the viability of the balances recorded. If the account relates to a non-refundable or non-recoverable item, the account should be charged-off. With respect to the Share Insurance Capitalization Deposit, the examiner should compare and reconcile the credit union's recorded deposit to that reported by the periodic statements from the Share Insurance Fund. Further comments on the Capitalization Deposit are provided in Section 15 of the Guide.

### 3.2-6 Accounts Payable, 800 Series

Accounts payable are monies that the credit union owes, including payroll deductions that have not yet been distributed to share accounts, remittances due for travelers' checks, insurance premiums due, etc. The examiner should determine that these accounts have been, or will be, audited, and the accounts should be reviewed for propriety. Material amounts should be checked to ensure that subsidiary ledgers are reconciled with control accounts and that payments are made when due.

### 3.2-7 Notes Payable, 810 Series

Notes payable are borrowings by the credit union. Borrowing to supplement capital needs can be either a reasonable management decision or can lead to financial disaster. When borrowing is part of a planned liquidity campaign with definite goals set and with limits on amounts, maturities, and rates, it can stimulate growth, help the credit union through a temporary period of tight money, and satisfy seasonal demands for cash. However, when borrowing is a stop-gap attempt to put cash in a depleted checking account, an illusion of liquidity, which quickly disappears, is created.

The key to borrowing is that it should be an action and not a reaction; it should be planned and not be a frantic search for cash without regard to other economic factors, such as interest rates, share growth, field of membership changes, etc.

A danger of borrowing is that the credit union may find that, while it was able to borrow at a rate less than its yield on assets, the rate can quickly increase to several points above the yield on assets. Unless the credit union is very liquid (often not the case if the credit union is borrowing), it may be unable to retire its notes payable; therefore, it must operate at a loss until the rates decrease or it is able to repay the funds.

### 3.2-8 Dividends Payable, 820 Series

This account is used only at the end of dividend periods to reflect the actual or estimated amount of a dividend which is due and payable to the members.

### 3.2-9 Interest Refunds Payable, 830 Series

Interest refunds are a method of returning part of the profits of the credit union to the members. Members who have paid interest on loans during the period get part of their interest back; 5 to 15 percent is a common range.

### 3.2-10 Taxes Payable, 840 Series

Taxes payable are accounts payable to governments, usually including Social Security, Federal, and state withholding. Although the amounts payable in taxes usually should not be a material item, the fines and penalties for nonpayment can often be substantial. Since NCUA does not enforce Internal Revenue Service or state tax regulations, the examiner's concern should be directed toward the prevention of tax problems for the credit union. Tax avoidance by employees can result in penalties, fines, and other tax-related problems for the credit union itself.

### 3.2-11 Accrued Expenses, 850 Series

Accrued expenses are the opposite of prepaid expenses, in that the credit union recognizes during the current period an expense that will be paid at a future point. An audit expense is one example; it is an expense for a prior period so it cannot be prepaid. Accruing expenses, like accruing income, more accurately presents the credit union's financial position.

An important accrued expense is accrued dividends payable. Credit unions which accrue dividend expenses on a more frequent basis than the actual dividend period should record the liability in General Ledger Account 854, Accrued Dividends Payable. Even for credit unions that use the modified cash basis of accounting, dividends contracted for and/or specified in advance, such as share certificates, must be accrued to comply with the full and fair disclosure requirements of Part 702 of the Rules and Regulations. As a minimum, the examiner should determine the reasonableness of the recorded dividend accrual on share accounts where the dividend rate is specified or contracted in advance. Many credit unions fail to properly disclose this liability.

### 3.2-12 Other Liabilities, 860 Series

Other liabilities include liabilities that are not recorded in previously discussed liability accounts, including liabilities under pension plans, collections on loans and other obligations serviced, obligations under capital leases, monetary control pass-through deposits, and undisbursed loan proceeds.

### 3.2-13 Exceptions, 870 Series

The Unapplied Data Processing Exceptions account allows the General Ledger to be reconciled with the Individual Share and Loan Ledgers when entries in the latter are rejected by the computer. For example, if a share withdrawal is posted to both the Journal and Cash Record (JCR) and to the Individual Share Ledger, but the account number was keyed to the computer incorrectly, the Share Ledger will be over the JCR by the amount of the withdrawal that was rejected. If the books are closed before a correction is made, the General Ledger will be out of balance with the Individual Share

Ledger. The exception is corrected by debiting a suspense account, Unapplied Data Processing Exceptions, in the General Ledger and crediting shares in the General Ledger, thus balancing that account to the Share Ledger. When the correction is made, shares will be debited and the suspense account will be credited.

The transactions in this account can become very complicated when compounded by payroll deduction errors, keypunch errors on refinanced loans with temporary disability insurance, corrections to prior period's dividends, etc., especially when a credit union first adopts an electronic data processing system. An unreconciled suspense account is a severe recordkeeping problem with the potential for material adjustments and losses.

### 3.2-14 Deferred Credits, 880 Series

Deferred credits represent income that potentially can be earned, but there are conditions which must occur prior to actual receipt of the income. An example is a credit union that buys loans from a liquidating credit union at 80 percent of their book value. The book value of loans is recorded as an asset, cash is credited for the purchase price, and the discount of 20 percent is recorded as Deferred Income. The credit union has the potential for collecting more than it paid for the loans but will not actually receive the additional income until after the purchase price of the loans has been collected.

### 3.3 Contingent Liabilities:

Contingent liabilities, or "off balance sheet" items, must be fully analyzed to determine the financial impact on the credit union being examined. Contingent liabilities can take many forms. Some examples are long term management contracts with employees, unrecorded sick or vacation pay of employees, long term contracts with data processing suppliers, long term leases for fixed assets and other contracts or employee pension plans. Contracts and pension plans are discussed in more detail below. Other contingent liabilities can involve situations such as where claims significantly exceed premiums on a select risk rating insurance plan. Often, when the impact of the contingent liability is recognized, this results in significant changes to the balance sheet or profitability position of the credit union.

Clues to the existence of contingent liabilities can often be found in the review of Board minutes. Contingent liabilities should also be noted in audit reports. Engagement letters from outside auditors typically request management to respond to questions concerning contingent liabilities. This engagement letter is usually included in the audit workpapers. Review of significant contracts and insurance policies, pension plans and accrued leave information will also allow for improved analysis of this area. Asking questions about the degree of involvement in these activities is important.

When significant contingent (unrecorded) liabilities are noted, the Examiner must determine full and fair disclosure requirements are met. This can be accomplished in several ways, such as the establishement of proper accrual accounts or footnotes to the financial statements.

The actual amount of the contingent liabilities which the examiner believes will become losses should be shown on NCUA 2047, Asset Share Ratios (if completed).

If the credit union's financial and statistical reports do not show contingent liabilities as footnotes, agreements should be reached that they will be shown on future reports. Such agreements should be described in the appropriate section of the examination report.

### 3.4 Valuation of Balance Sheet Accounts

The examiner will evaluate assets and liabilities and apply judgemental factors to these accounts in accordance with the instructions on NCUA 2047, Asset Share Ratios (if completed), to compute a Probable Asset Share Ratio.

### 3.5 Individual Share and Loan Ledgers

Credit unions use many different accounting systems to keep track of Individual Share and Loan accounts: hand posting ledger books or on ledger cards, magnetic stripped bookkeeping machines, in-house computers of various capacities, and outside service bureaus. Each system has some differences from the others; the examiner should take the time to become familiar with each system as it is encountered. Although the systems have differences, they share a common purpose of serving as a means to maintain the subsidiary ledgers to General Ledger control accounts.

In smaller credit unions, there usually will be two subsidiary ledgers and two control accounts: the Individual Share and Loan Ledgers and the General Ledger Share and Loan accounts. In larger or more complex credit unions, there may be many subsidiaries for both shares and loans, including separate ledgers for real estate loans, student loans, consumer loans, regular shares, share drafts, etc. In all cases, it is important that the subsidiary ledgers are in balance with the control account and that the total of subsidiary ledgers for both shares and loans are in balance with their respective General Ledger accounts. The examiner may wish to use the optional NCUA 2105, Subsidiary Ledgers, if it will assist in the analysis of subsidiary ledger differences.

### 3.5-1 Ledgers Out Of Balance

If the trial balance totals of the Individual Share and Loan Ledgers do not agree with their respective control accounts in the General Ledger, or if one or more subsidiary ledgers do not agree with their respective control accounts, the out-of-balance condition could represent varying degrees of seriousness. These could vary from an innocent error in extension of balances to an embezzlement of sizeable proportions. The examiner should guide the officials in devising procedures that fit the situation.

Regardless of the mechanics required to correct the out-of-balance condition, the examiner must make it clear to the treasurer and the board that the treasurer has the responsibility to keep the books and records current and in balance. An auditor, the board, or an examiner can never be sure of the real reason for an out-of-balance condition until the errors causing the differences have been located and analyzed. In any case, regardless of the reasons, it is the board's responsibility to determine that the problem is promptly corrected. The first step must be to establish the reasons for the errors, to correct the cause, and to prevent a recurrence. It is of equal importance to locate and to correct the existing errors.

The examiner should consider:

(1) Why the accounts are out of balance. To do this, the examiner may need to search for representative errors. Once representative errors are located, it should be possible to:

a. Detect a specific type or pattern of errors, develop specific plans of action with the officials to find all errors, balance the ledgers, and eliminate the causes; and

b. Detect a discrepancy, if one exists.

The examiner should not attempt to balance the records, nor spend considerable time searching for errors after pinpointing the type of error(s) being made, unless dishonesty is evident. If dishonesty is evident, the examiner will consult with the Supervisory Examiner before proceeding with additional test checks.

(2) The materiality of the differences. All out-of-balance conditions must be resolved. However, a difference which could affect the financial condition of the credit union is more critically important to correct than is a difference of a few dollars made in a recent dividend calculation.

(3) The degree of fluctuation. Even though the amount may be substantial, a stable difference is less critical than a difference which fluctuates from period to period. A stable difference usually occurred in an identifiable, specific period and does not usually represent a continuing problem with internal controls and recordkeeping. It may represent only a one-time occurrence. A fluctuating difference means that there are continuing problems with the personnel and/or equipment (often both).

### 3.5-2 Arbitrary Adjustments

If differences are not material and there have been no fluctuations during the previous 3 months, the examiner should request the directors and the supervisory committee to authorize the differences to be arbitrarily adjusted in accordance with the instructions in the Accounting Manual.

### 3.6 Records Seriously in Arrears or General Ledger Out Of Balance

When any of the credit union records (General Ledger, Journal and Cash Record, Individual Share and Loan Ledgers, or material subsidiary ledgers) are in arrears more than 20 days and cannot be brought current during the examination, consideration should be given to delaying the completion of the examination until the records are current. This should also be the case if the General Ledger is out of balance. If the examination is delayed, the examiner will reach agreements with the officials to correct the problem.

Normally, the examination should not be delayed more than 30 days. If the delay will be longer than 30 days, the examiner should discuss the situation with the Supervisory Examiner and get concurrence with plans prior to reaching agreements with officials. The agreements reached with officials should be recorded on NCUA 2035, Record of Action.

If the examination is delayed, the examiner will prepare a memorandum explaining the circumstances surrounding the situation, including the date when the examination will be resumed. The Record of Action should be an enclosure to the memorandum. Copies of the memorandum should be furnished the regional office and the Supervisory Examiner. A full explanation of the facts in the case will be reported in the narrative sections of the examination report.

If, upon returning to the credit union, the examiner finds that the officials have failed to follow through on agreements reached, the examination will be completed using the most current meaningful data available. As appropriate, the examiner will discuss the situation with the Supervisory Examiner and come to an agreement on how best to handle the situation, in accordance with regional policy.

Administrative action may be warranted in credit unions with persistent and extreme recordkeeping problems. In these instances, when available earnings cannot be determined because an accurate financial statement has not been prepared, the declaration of dividends should not be permitted until the board of directors can determine if a legal dividend can be paid.

### 3.7 Material Contracts:

All material contracts entered into by the credit union during the exam period should be reviewed. The extent of analysis will depend upon the impact on the credit union, either singularly or collectively. The ability to fulfill the terms of long-term contracts should be assessed. Examples of material contracts can include management contracts, agreements with a data processing servicer or long term leases on land, building or equipment. Contracts for items such as a general maintenance or service agreement usually would not be considered material and would usually be a short term agreement.

The Examiner will normally limit the review to an assessment of the financial impact on the credit union. Questions concerning legality should be cleared with the officials, the Supervisory Examiner, or the Regional Office, as appropriate. Unresolved legal questions will be sent to the Regional Office, accompanied by a copy of the contract.

General Counsel has recently ruled that Examiners do have the right to review and examine employee management contracts. However, the Examiner must be guided by the fact that management agreements are confidential documents. The terms of such agreements may not be disclosed to anyone outside NCUA and may be disclosed to persons within the Agency only when necessary to promote the safety and soundness of the credit union's operation.

### 3.8 Pension Plans:

A pension plan is an agreement between a company and its employee group whereby the company promises to provide income to its retired former employees. The retirement income is generally determined on the basis of the employee's income and length of service to the company. Pension plans may be either funded or unfunded. Under a funded plan, the company typically makes payments to a funding agency that assumes the responsibility for safekeeping and investing the pension funds and for making payments to the recipients of the benefits. An unfunded plan is one in which no periodic payments are made to an external agency; the pension payments are made from current company resources. Congressional actions such as the Employee Retirement Income Security Act of 1974 (ERISA) has greatly reduced the existence of unfunded plans; it has brought about the emergence of many partially funded plans, which require a different accounting treatment.

Partially funded plans can be accomplished in numerous ways and, like other plans, can be either contributory or noncontributory. Under a contributory plan, employees bear a portion of the cost through contributions from their wages into the pension fund. The entire cost of the plan is borne by the company in a noncontributory plan.

Although Federal credit unions are tax exempt, most design their pension plans to meet the Internal Revenue Code qualifications, which allow:

1. Employer contributions to be deductible for income tax purposes.
2. Pension earnings not be subject to income taxes.
3. Employer contributions to the pension fund are not to be taxable to the employees until pension benefits are actually received.
4. Employee contributions to the pension fund are not to be taxable until pension benefits are actually received.

### 3.8-1 Accounting for Pension Cost

When a pension plan is adopted, actuarial tables are used to determine the past service cost and the normal cost. Once the amounts are ascertained, a funding policy for the costs is established. Normal costs are usually funded in the year they are expensed and incurred. The funding policy for past service costs also effects the amount of recorded expenses for any period. However, remember that there is no requirement for the amounts of pension expense related to service costs and of cash put into the fund to finance these costs in any one period to be equal. The funding and expense policies adopted by a particular credit union will result in one of the following situations:

1. The amount of recorded pension expense and cash paid into the fund are equal. This situation can only arise when the amortization and funding period for past service costs are equal. In this example, there is no requirement to establish an account in the General Ledger for any over or under accrual of the liability for pension costs.

2. The amount of recorded pension expense exceeds the amount paid into the fund, creating a pension liability. This situation arises when the funding period for past (and changes in prior) service costs is longer than the expense amortization period. General Ledger Account 861, Liability Under Pension Plan, is used in this example.

3. The amount of recorded pension expense is less than the amount paid into the fund, creating a pension asset. This situation arises when the funding period for past (and changes in prior) service costs is shorter than the expense amortization period. General Ledger Account 767, Deferred Pension Cost, is used in this example.

Section 6000 of the Accounting Manual for Federal Credit Unions is used for a discussion and illustrated entries on the proper accounting treatment for pension plans. As credit unions grow larger and employ more persons, credit union pension plans play an increasing role in the expense structure of a credit union. Proper accounting and the need for full and fair disclosure become increasingly necessary.

## 3.9 Workpapers and References

(1) Workpapers

- a. NCUA 2047, Asset Share Ratios
- b. NCUA 2050, Statement of Financial Condition
- c. NCUA 2051, Statement of Income
- d. NCUA 2095, Trial Balance
- e. NCUA 2105, Subsidiary Ledgers

(2) References

- a. NCUA Rules and Regulations
  - 1. 701.38 - Borrowed Funds From Natural Persons
  - 2. 702 - Full and Fair Disclosure

- b. Accounting Manual for Federal Credit Unions

- c. Federal Credit Union Bylaws
  - 1. Article VIII, Section 5 - Treasurer's Duties

## 4. Reserves

There are two general types of reserves that are applicable for credit unions: equity reserves and cash reserves. Cash reserves may include, for example, transaction account reserves required by Regulation D. Cash reserves generally have limited applicability to smaller credit unions. On the other hand, equity reserves are applicable to all credit unions and are discussed in this section.

Equity reserves are established by segregating part of the income received by the credit union into reserve and undivided earnings accounts. These reserves do not affect the cash operations of the credit union.

Equity reserves are reviewed to determine that:

(1) Policies, practices, and procedures regarding reserve accounts are adequate;

(2) Officials and employees are operating in conformance with established guidelines;

(3) Reserve accounts are audited acceptably;

(4) The credit union is in compliance with the Act, the Rules and Regulations, and the Accounting Manual; and

(5) Corrective action is initiated when policies, practices, procedures, or internal controls are deficient or when violations have been noted.

### 4.1 Reserves and Undivided Earnings, NCUA 2220

The depth of the review of the reserve accounts will depend on the overall reserve adequacy, reserve trends, materiality, unusual activity, and thoroughness of the supervisory committee audit work. If a detailed review is necessary, NCUA 2220, Reserves and Undivided Earnings, is an optional workpaper which may be used to analyze two of the credit union's equity reserves. Instructions for completion are on its reverse. The workpaper is designed to allow the examiner to make a determination of the credit union's compliance with reserve transfer requirements and to analyze patterns of equity account activity during the examination period. Particular attention should be paid to trends in the Regular Reserve and the Undivided Earnings accounts. The completion of the analysis of the Regular Reserve and the Undivided Earnings accounts will be recorded on NCUA 2055, Examination Scope.

### 4.1-1 Regular Reserve

The primary purpose of the Regular Reserve account is to function as a financial stability reserve. If the credit union is properly maintaining the Allowance for Loan Losses, the balance in the Regular Reserve will represent the "free" portion (the amount beyond the immediate collection problem loan needs of the credit union) of the statutory reserve which is available for future losses on uncollectable loans.

The examiner may consider at least the following when analyzing the adequacy of the balance in this account:

(1) Ratio of valuation allowance and reserve balance to total loans;

(2) Loss experience of the credit union;

(3) Ratio of classified loans to the Allowance for Loan Losses;

(4) Ratio of classified loans to the total of the Allowance for Loan Losses and the Regular Reserve;

(5) Present and anticipated earning capacity of the credit union;

(6) Loan risk diversification;

(7) Quality of the loan portfolio (overall assessment); and

(8) Unpredictable events, such as adverse economic conditions causing plant closings, layoffs, etc.

The total analysis process should be carefully applied to the review made of this and other reserve accounts. If reserves are inadequate, the causes should be reviewed in detail with the officials.

When the aggregate of the Regular Reserve and the Allowance for Loan Losses exceeds the maximum applicable percentage established by Section 116 of the Act and Section 702.1 of the Rules and Regulations the board may transfer the excess to Undivided Earnings. Prior to authorizing such a transfer, the board must consider the present and the anticipated reserve needs and must ensure that full and fair disclosure requirements are met.

There is no authority for an examiner to ask the board to make a transfer to the Regular Reserve beyond that required by Section 116 of the Act. The examiner has the responsibility, however, to review reserve weaknesses with the board and to discuss the various alternatives that exist to strenghten the credit union's reserve position. Most of these alternatives require voluntary action on the part of the board. The examiner should carefully avoid giving the impression that transfers beyond legal requirements are compulsory.

### 4.1-2 Undivided Earnings

The examiner should determine that the Undivided Earnings account is being maintained in accordance with instructions contained in the Accounting Manual, with specific attention given to its growth trend. If there is a deficit balance in this account, or if the balance has been decreasing for several consecutive periods, or is so low that future dividends might be jeopardized, the examiner should determine the reasons and work with the officials to correct the problem.

If a deficit balance is present in the account, the examiner should determine if a dividend was paid during the last accounting period. If a dividend was paid and the examiner believes there was obvious intent on the part of the officials to pay an illegal dividend, and the amount involved is material, then, an administrative action against the responsible parties should be considered. Also, consider notifying surety regarding the intent to pay an illegal dividend. The examiner should not recommend that the officials recall the dividend because neither the officials nor the NCUA Board has that authority;

if the shareholders received the illegal dividend in good faith and without knowledge of the credit union's financial condition, they have no legal obligation to refund the dividend. The examiner should reach an agreement with the officials that the dividend declared at the end of the next accounting period will not exceed available earnings after elimination of the deficit. The matter should be treated as an area of concern.

### 4.2 Allowance for Loan Losses, NCUA 2210

The primary objectives in analyzing the Allowance for Loan Losses account are to determine that:

(1) Management employs proper accounting procedures;

(2) Officials understand the function and the purpose of the account; and

(3) The account balance accurately reflects full and fair disclosure of classified loans.

Technically, the account represents a segregation of the Regular Reserve. The balance should be added to the Regular Reserve when computing ratios involving irrevocable reserves and should be considered part of the Regular Reserve for determining the percent of gross income to be transferred to the Regular Reserve at the close of each accounting period.

The Allowance for Loan Losses should represent a reasonable estimate of loan portfolio losses; its adequacy should be determined during each examination. The balance of the account should be at least sufficient to provide for classified loans. The examiner will use judgement as to the handling of the matter in the written report. The concept of materiality and the overall financial condition of the credit union should be taken into consideration when making a judgement. The examiner will record the extent of the Allowance for Loan Losses analysis on NCUA 2055, Examination Scope.

If the examiner finds that the Allowance for Loan Losses is inadequate but that the Regular Reserve is sufficient to cover the additional amount needed, the officials should be advised to increase the Allowance for Loan Losses in accordance with the Accounting Manual.

The examiner may encounter credit unions where both the Allowance for Loan Losses and the Regular Reserve are insufficient to cover classified loans and the officials have failed to establish an adequate valuation allowance from other accounts as prescribed in the Accounting Manual. The officials should clearly understand that they will be expected to meet the intent of the full and fair disclosure provision of the regulation prior to the distribution of any future dividend. The examiner's approach to this should be tempered by the seriousness of the situation and may vary from giving instructions to the officials for the next accounting period to recommending an administrative action.

There may be times when the officials fail a second time to conform to the intent of the full and fair disclosure provision of the regulation, even though specific examiner instructions were given during a previous examination. In these cases (depending on the seriousness of the estimated reserve deficiency), the examiner should consider the various administrative actions discussed in the administrative remedies of the guide which might be used to correct the problem.

### 4.3 Value of Retained Earnings

The term retained earnings can be used to indicate the total of a credit union's regular reserve, special reserves and undivided earnings. (For regulatory purposes the Allowance for Loss account is considered a part of the regular reserve). These accounts exist to provide a cushion for losses (anticipated and unidentified), a base for future growth and to enable the credit union to meet competitive pressures as they arise.

The stronger the overall retained earnings position the more likely a credit union will be able to deal with losses. For this reason, the examiner should review the retained earnings psoition and the officials' philosophy towards building and maintaining retained earnings. If retained earnings do not meet the short-and/or long-term needs of the credit union, the examiner should first determine if the short fall could pose a threat to safety and soundness. Consideration must be given to such issues as the age of the credit union, its past financial performance, the amount of the short fall, and whether increasing retained earnings would have a negative impact on the ability to declare a reasonable dividend. Taking these issues into account, the examiner should consider developing a record of action to resolve the problem.

### 4.4 Workpapers and References

(1) Workpapers

  a. NCUA 2210, Allowance for Loan Losses
  b. NCUA 2220, Reserves and Undivided Earnings

(2) References

  a. Federal Credit Union Act
    1. 116 - Reserves

  b. Federal Credit Union Bylaws
    1. Article XIII - Reserves

  c. NCUA Rules and Regulations
    1. 702.1 - Reserves
    2. 702.2 - Regular Reserve
    3. 702.3 - Full and Fair Disclosure Required

  d. Accounting Manual for Federal Credit Unions.

## 5. Profitability

Profitability should be analyzed during all examinations. The examiner will record the completion of the profitability analysis on NCUA 2055, Examination Scope. The examiner's objectives during this analysis are to determine:

(1) If policies, practices, and procedures regarding income and expenses are adequate;

(2) If the credit union's earnings are sufficient to provide for all operating expenses, dividends and reserve transfers;

(3) If the relationship between the cost of capital and the income generated from capital is adequate;

(4) If the credit union is recording income and expense items in accordance with the Accounting Manual and applicable laws, regulations, and policy statements; and

(5) If corrective action is to be initiated when policies, practices, and procedures are inadequate or when exceptions to the Accounting Manual, laws, regulations, and policy statements are disclosed.

NCUA 2051, Statement of Income, is an optional form which may be used to develop basic information about a credit union's profitability. It will give an overall picture of income and expense and assist in projecting future earnings. Instructions for completing the form are on its reverse.

### 5.1 Statement of Income, NCUA 2051

NCUA 2051, Statement of Income, will be completed and will become a part of the Supervisory Examination Report when the credit union's income statement is not current or is materially incorrect as of the effective date of the examination. The examiner should use NCUA 2095, Trial Balance, when material adjustments are made. Adjustments will be explained on the Trial Balance workpaper and will be entered by the credit union personnel in the credit union's records.

The final figure in each column of the Statement of Income represents the Net Income (Loss) From Operations; the "bottom line" after accounting for all income and expense items, including reserve transfers, for the period under review.

The net reserve transfer adjustment is calculated by subtracting the provision for loan loss expense from the required transfer to the regular reserve; however, the result may not be less than zero. This adjustment recognizes that the provision for loan loss expense is a legitimate expense for the period under review, but that the portion of that expense which is equal to or less than the required reserve transfer represents a "double transfer" to irrevocable reserves.

If necessary, the examiner may prepare additional schedules to analyze the breakdown of items, such as miscellaneous income, cash over and short, travel and conference expense, or any non-operating expenses.

NCUA 2051 may also be used to estimate the effect of material items, such as income from loans and/or investments, dividends, and reserve transfers through the effective date of the examination, on a pro forma Statement of Income. The estimations will provide a more accurate analysis tool by showing the results of operations under a full accrual accounting method. This will enable the examiner and the officials to be more aware of the credit union's financial condition and to plan for the future. In some cases, footnotes to the credit union's financial statements may serve the same purpose.

The amounts on NCUA 2045, Examination Financial Data, and the ratios on NCUA 2046, Key Ratios, will generally reflect the balances on NCUA 2051, Statement of Income. When pro forma balances are estimated, the pro forma balances will generally be shown on NCUA 2045, Examination Financial Data.

### 5.1-1 Pro Forma Estimations

Material items such as dividends, reserve transfers, and operating expenses, may be estimated whenever an examination is performed as of a date other than the end of an accounting period. The estimates should be materially accurate to show whether the credit union will be able to declare its anticipated dividend and the net effect upon the equity accounts. These estimates should be included in the pro forma column of the Statement of Income.

Dividends can be estimated by determining the average of the prior two periods' dividend-to-shares ratio and by multiplying the ratio by the average shares outstanding since the previous dividend.

For example:

Assume a November 30 examination in a credit union which pays dividends quarterly.

On June 30, the average share balance for the quarter was $350,000 and the dividend cost was $3,938. The dividend-to-shares ratio is $3,938/$350,000 = .01125.

On September 30, the average share balance for the quarter was $400,000 and the dividend cost was $4,700. The dividend-to-shares ratio is $4,700/$400,000 = .01175.

The average of the prior two periods' dividend-to-shares ratio is (1.125% + 1.175%)/2 = 1.15%.

Since September 30, shares have totaled $475,000 as of October 31 and $525,000 as of November 30. The average of shares since the previous dividend period is ($475,000 + $525,000)/2 = $500,000.

Multiplying the average shares by the dividend-to-shares ratio yields $500,000 X 1.15% = $5,750, which is the current period's estimated dividend. Since the credit union in this example pays quarterly dividends, only two-thirds or $3,833 is recorded as the estimated dividend through the effective date of the examination.

The dividend-to-shares ratio is multiplied by the number of dividend periods in a year to yield the effective annual cost of shares.

4 X 1.15% = 4.6% cost of shares

## 5.2 Analysis of Profitability

Five key profitability ratios are computed on NCUA 2046, Key Ratios, during each examination. Instructions for computing the ratios are on the reverse of the form. Guidance in analyzing the ratios is given in the Total Analysis Process section. In addition to computing and analyzing the ratios on NCUA 2046, the examiner should supplement this analysis with data on the Financial Performance Report (FPR).

## 5.3 Extended Analysis of Profitability

If adverse trends are apparent in the profitability ratios on NCUA 2046, Key Ratios, and/or on the FPR, the analysis can be extended, using individually designed workpapers or NCUA 2075, Spread Analsys Worksheet, to determine the cause. Material income or expense items (investment income or dividend expense) not recorded on a credit union's records should be estimated and included. The examiner can compare ratios to the most recent month, quarter, year, the previous examination, or the FPR. The examiner can also use the ratios to "forecast" or "project" the effects of adverse trends on profitability for a future period.

For example:

Assume the following assumptions which are based on annualized growth rates (or lack of growth) for the past year:

### SPREAD ANALYSIS WORKSHEET

ESTIMATED BALANCE SHEET

| | | |
|---|---|---|
| 1. | Share growth for Year | 9.2% |
| 2. | Asset growth for Year | 9.5% |
| 3. | Loan growth for Year | 9.0% |
| 4. | Investment growth for Year | |
| | OR | |
| a. | Investment to Asset Ratio at Year End | |
| | OR | |
| b. | Loans and Investments to Asset Ratio (Solve for Investment Ratio) | 97.5% |

ESTIMATED AVERAGE YIELDS, COSTS OR RATIOS

| | | |
|---|---|---|
| 1. | Yield on Loans | 13.8% |
| 2. | Yield on Investments | 10.9% |
| 3. | Cost of Funds | 8.3% |
| 4. | Other Income as a percentage of Assets | .04% |
| 5. | Operating Expenses (Less PLL) to Assets | 3.9% |
| 6. | Statutory Reserve Transfer to Gross Income | 5.0% |

These assumptions are applied to the balance sheet amounts by using the following simplified projection worksheet.

| BALANCE SHEET | (A)<br>Actual as of 12-31-85 | *Assump | (B)<br>Projected as of 12/86 | | ((A) + (B) ÷2)<br>Avg Bal Sheet 1986 | (C)<br>% To Total Assets | (D)<br>Estm Yield/ Cost | (C) x (D)<br>Period Spread |
|---|---|---|---|---|---|---|---|---|
| ASSETS | | | | | | | | |
| LOANS | $4,120,240 | 1.09 | $4,491,062 | **57.52% | $4,305,651 | 57.65% | 13.8 | 7.96% |
| INVESTMENTS | $2,828,874 | | $3,121,458 | ***39.98% | $2,975,166 | 39.83% | 10.9 | 4.34% |
| OTHER | $181,069 | | $195,030 | | $188,050 | 2.52% | 0 | |
| TOTAL | $7,130,183 | 1.095 | $7,807,550 | *97.50% | $7,468,867 | 100.00% | | |
| Plus: Other Income To Avg Assets | | | | | | | 0.04% | |
| Yield on Assets | | | | | | | 12.34% | |
| LIABILITIES AND CAPITAL | | | | | | | | |
| SHARES+N.P. | $6,685,096 | 1.092 | $7,300,125 | | $6,992,610 | 93.62% | 8.3 | 7.77% |
| OTHER | $445,087 | | $507,425 | | $476,257 | 6.38% | 0 | |
| TOTAL | $7,130,183 | 1.095 | $7,807,550 | | $7,468,867 | 100.00% | | |
| Gross Spread | | | | | | | 4.57% | |
| Less: (a) Oper Expenses to Avg Assets | | | | | | | 3.90% | |
| Net: (b) Reserve Transfer to Avg. Assets | | | | | | | 0.62% | |
| NET SPREAD | | | | | | | 0.05%* | |
| *Conversion to Dollars: (Net Spread x Avg Assets) | | | | | | | $3,707<br>======= | |

*** Per 4(b) Assumption on the Estimated Balance Sheet Example**

**** Percent of Projected Loans to Total Assets**

*****Percent of Investments (Total Assets Less Loans). This percentage times Total Assets equals the Projected Investments. The "other" projected amount is the remaining difference in assets.**

This simplified worksheet can be expanded to include a breakdown of different loan and share mixes as well as other balance sheet items depending on the complexities of the credit union. The worksheet can also be used to test the credit union's budget assumptions.

### 5.3-1 Yield on Assets

The yield on assets shows the rate at which the assets produce income and normally will be less than the credit union's interent rate on loans because assets include such nonearning items as prepaid expenses, furniture and equipment, etc. If the yield on assets is low or the trend in the ratio is negative, the examiner can extend the analysis to determine the casue of the decreased income. Unusual change in a positive direction also should be analyzed. The yield on loans, yield on investments, and yield on major assets can assist the examiner in this determination. If these ratios do not point out the cause of an adverse trend in the yield on assets, the examiner should be alert to a major fixed asset purchase or some other increase in nonearning assets. Further discussion on the yield-on-assets ratio is contained in the Total Analysis Process section of the Guide.

### 5.3-1.1 Yield on Loans

The yield on loans is the rate at which loans produce income. This ratio usually will be less than the interest rate charged for loans because it does not consider interest due on delinquent loans unless that interest has been accrued. If the yield on loans shows a negative trend, the reasons may include an increase in delinquency, decreased collections, or a reduction in interest rates.

### 5.3-1.2 Yield On Investments

The yield on investments is the rate at which investments produce income. The ratio will be the average of all individual investment yields and should be reflective of general interest rate trends.

### 5.3-1.3 Yield on Major Assets

The yield on major assets is the combined rate at which loans and investments produce income. A change in yield could point out either a change in yield on loans and/or investment or a change in the allocation of funds between loans and investments. For example: for the two periods being compared, a credit union has a yield on loans of 15 percent, but the yield on major assets declined from 14 percent to 12 percent. The reason for the decline in yield on major assets would probably be due to a shifting of funds out of loans and into the lower yielding investments. The cause of the shifting in funds should be determined. The cause could include declining loan demand, seasonal fluctuations, or a planned management strategy.

### 5.3-2 Operating Expenses to Assets

Operating expenses to assets shows the percentage of assets used for operations. If this ratio is high or if the trend shows an increase, the cause should be determined. Further guidance in analyzing this ratio is given in the Conclusions - Total Analysis Process section.

### 5.3-3 Cost of Funds to Assets

Cost of funds to assets shows the percentage of assets used for dividends and interest on borrowed money. If this ratio is high or the trend shows an increase, the cause should be determined. The cost of shares and the cost of borrowed money ratios can assist the examiner in this determination. Further discussion on the cost of funds-to-assets ratio is contained in the Conclusions-Total Analysis Process section.

### 5.3-3.1 Cost of Shares

The cost of shares shows the effective cost of equity capital. It will show the effects of new share policies, such as the introduction of money market certificates, day-of-deposit dividends, or other changes.

### 5.3-3.2 Cost of Borrowed Money

The cost of borrowed money shows the cost of borrowed capital as opposed to equity capital. The market for borrowed funds can be extremely volatile. The key to a large increase in the cost of borrowed money is the credit union's reaction to the increase. The dollar amount of borrowed money should decline as the cost for that money climbs.

### 5.3-4 Net Income (Loss) After Dividends To Assets

The ratio of Net Income (Loss) After Dividends to Assets is the percentage of assets that the credit union realizes as profit before net reserve transfers. If in the two periods being compared the most recent ratio is less than the previous ratio, or if the ratio is negative, the examiner should determine the cause. For a further discussion on this ratio, see the Conclusions - Total Analysis Process section.

### 5.3-5 Net Income (Loss) From Operations To Assets

The ratio of Net Income (Loss) From Operations to Assets is a key credit union profitability indicator. The ratio considers all sources of income and all uses of that income (operating expenses, cost of funds, and net reserve transfers) to arrive at the percentage of assets that is profit. Guidelines on analyzing the ratio are given in the Conclusions - Total Analysis Process section.

If the ratio is currently negative, the cause must be determined and corrective steps must be taken. The urgency of the situation depends on the trend in the ratio and available reserves. A negative trend shows a worsening situation that will be more difficult to correct than a stable or improving trend. Available revocable reserves and earnings are of vital importance because they dictate how much time the credit union can support negative earnings without affecting dividends or operations. For example, a \$2 million credit union has \$22,000 in Undivided Earnings and a negative Net Income (Loss) From Operations ratio of -.6%. The credit union will lose .6% x \$2,000,000 per year, or $12,000 under present conditions, unless it corrects its problems. Therefore, the credit union has 22 months or less to implement any strategies and/or operating efficiencies. However, if the -.6% were the 12-month ratio, and -.9% were the 3-month ratio, the period in which corrections must be made is drastically reduced. The longest time available can be determined by first calculating the annual loss and then converting it to months:

.9% x $2,000,000 = $18,000 / 12 months = $1,500 lost per month.

At that rate, the credit union will deplete its $22,000 in Undivided Earnings in a maximum 15 months. However, the rate of loss is accelerating. The ratio deteriorated from -.6% to -.9% during the period. Assuming that the credit union has 15 months in which to operate assumes a linear increase in the rate of loss. A review of the ratio should reveal if this is a valid assumption or if there is actually less time to correct the problem.

The objective is to correct the problem(s) which caused the negative trend. Any examiner-designed workpaper should assist in determining the cause(s) of any negative trend and lead toward a specific Record of Action to document agreements reached with the officials. When necessary, the examiner should use the Supplementary Facts, the Projection Worksheet and/or any other examiner-designed worksheet to highlight and explain the key ratios to the oficials which will increase their understanding and gain assurances that proper corrective action will be taken.

### 5.4 Workpapers and References

(1) Workpapers

a. NCUA 2045, Examination Financial Data
b. NCUA 2046, Key Ratios
c. NCUA 2051, Statement of Income
d. NCUA 2055, Examination Scope
e. NCUA 2060, Key Trends and Ratios
f. NCUA 2075, Spread Analysis Worksheet

NCUA MISSION

## NCUA MISSION

## TABLE OF CONTENTS

Page

**1. Mission of the National Credit Union Administration (NCUA)**

1.1 Supervision Policy 1
1.2 Responsibility for Supervision of Credit Unions 3
1.3 Examiner's Role - District Management 3
1.4 Workpapers and References 5

## 1. Mission of the National Credit Union Administration (NCUA)

Notes

"The mission of the National Credit Union Administration is to secure the financial soundness of credit unions, assure the safety of member funds, and assure compliance with laws and regulations; to support credit union liquidity; to encourage credit unions to operate as consumer financial cooperatives encouraging thrift and providing financial services and credit to persons of ordinary means; to encourage credit unions to educate members to maintain and improve their financial stability; to facilitate credit union development; and to manage the Agency's resources in an effective and efficient manner." (Excerpt from NCUA Long-Range Plan)

The mission of the National Credit Union Administration is accomplished through the most effective supervision of credit unions possible with the resources available. This supervisory effort consists of:

(1) Identifying individual credit unions with serious financial and operational problems. The identification process includes the use of the Financial Performance Report (FPR) and the semiannual Financial and Statistical Report, NCUA 5300, as well as direct contacts with credit union management during examinations, follow-up examinations and other visits.

(2) Ensuring credit union management initiates timely and effective corrective action by following up on agreements contained in Records of Action and in letters to and from credit unions or by taking formal administrative actions.

(3) Identifying trends in credit unions which may have adverse effects on their financial conditions and operations and/or the National Credit Union Share Insurance Fund (NCUSIF). These trends might result in changes to NCUA examination or supervision policies or in recommending legislative or regulatory changes which affect credit union operations.

(4) Educating credit union management and NCUA staff of trends and potential problems which may adversely affect the financial condition and operations of credit unions. This educational process is achieved in part through supervisory letters, articles written in NCUA publications, and verbal and written communications by NCUA examiners during examination and supervisory contacts.

### 1.1 Supervision Policy

Section 111 of the Federal Credit Union Act (Act) places the responsibility for managing the affairs of a Federal credit union with its board of directors, a supervisory committee, and where the Bylaws

Notes

so provide, a credit committee. The powers and the duties pertaining to the responsibility of the officials are contained in Sections 113, 114 and 115 of the Act and in the Federal Credit Union Bylaws (Bylaws). In general, the board of directors is responsible for establishing and controlling the implementation of policies which ensure successful operation of the credit union and compliance with applicable laws. Credit unions should operate with minimal NCUA supervision provided their policies and procedures ensure successful operations and compliance with applicable laws and are projected to do so in the future.

NCUA's supervisory role will be expanded in an individual credit union only in instances where its officials are unable or unwilling to implement policies and practices which ensure the financial soundness of the credit union, safety of members' funds, and compliance with laws and regulations. The degree of supervision, which will be determined on an individual basis, will be based upon the viability of the credit union, the seriousness of the problem(s), the capabilities of management, the cost to NCUA, and the risk to the NCUSIF.

Consideration should be given to the impact of supervisory effort as well as to the need for such effort. For instance, some credit unions historically have responded to supervisory efforts by correcting problems only to have those same or similar problems resurface during the next contact. Supervision which results in temporary correction of a problem is neither effective nor efficient. Credit unions which require such supervision should be reviewed to determine:

(1) If the problems cited are, in fact, problems for those particular credit unions. For instance, some credit unions historically have delinquent loan ratios which are higher than generally considered acceptable, yet actual losses are reasonable. With added management control, delinquency can be reduced to a more "acceptable level" only to be increased when examiner follow-up ends. In fact, an "acceptable level" of delinquency for this group may be higher than normal and added supervision in the long run is unnecessary.

(2) If the credit union's economic viability warrants the amount of supervision provided. In cases where problems are serious and temporary correction is effected only to have the problems recur again and again, and where the credit union has little or no viability without constant supervision, serious consideration should be given to alternative methods of providing credit union service to the members.

Once it is determined that a credit union has problems which warrant added NCUA supervision, firm and result-oriented action will be taken. Clear agreements with dates for completion will be reached and documented during examiner contacts and appropriate follow-up will be established. In a more serious and/or persistent case, the Regional Director may issue a letter requiring correction of problems or compliance with law. When normal supervisory efforts do not correct the problem, an appropriate administrative action will be initiated.

Every effort will be made to have officials resolve problems as quickly as possible once they are identified. Credit unions with persistent or recurring problems should address the real problem. Credit unions which operate with serious and/or persistent problems are not complying with the Act and the Bylaws and jeopardize their existence as separate entities.

### 1.2 Responsibility for Supervision of Credit Unions

The NCUA Board is ultimately responsible for the supervision of credit unions through its supervision policies. In the regions, the Regional Director is responsible for the supervision of credit unions, as well as the assignment of resources to carry out NCUA policies. Likewise, the Supervisory Examiner is responsible for allocating group resources to supervise assigned credit unions, and the examiner is directly responsible for credit union supervision in the district, all within NCUA policy. These responsibilities are carried out by the examiner without additional guidance, except in complex situations or when consultation is required with the Supervisory Examiner.

NCUA supervisory policy must be flexible enough to allow the allocation of available resources to the most critical areas. Thus from time to time, the Regional Director will make decisions that may not concur with those of the Supervisory Examiner and/or District Examiner simply because greater priorities are present elsewhere in the region.

### 1.3 Examiner's Role - District Management

The examiner is NCUA's representative and must project a professional image when contacting credit union officials, management and employees. The examiner should demonstrate a courteous, businesslike, and cooperative attitude which reflects well on NCUA, as well as on the examiner. The exercise of good judgment and integrity is essential in fulfilling the role of an examiner.

The examiner is NCUA's closest representative with credit unions and thus is in the best position to analyze their financial condition, evaluate their management, and assist officials in their operations. The examiner is also in the best position to determine the amount and the scope of supervision that needs to be given to each credit union in the district.

Each examiner is responsible for a district. The number of credit unions in a district is governed by the experience of the examiner and the size, complexity, and geographical location of the credit unions. Each district is designed so that the examiner can conduct examinations and provide supervision in accordance with NCUA

**Notes**

Board policy. NCUA 2049, Schedule of Contacts, can be used in planning and controlling district assignments.

The primary responsibility of the examiner is to ensure the safety and soundness of credit unions within the district. The examiner must manage time and resources in the most efficient and effective manner but must be flexible enough to adjust priorities in the event of critical situations. Likewise, when contacting a credit union, the examiner must not dwell on immaterial detail. Excessive time spent in one credit union can jeopardize supervision time available for other credit unions and/or the accomplishment of NCUA's mission and goals. The ability of the examiner to balance the use of resources and the results derived is critical to district management.

The examiner has numerous resources to manage a district. Oral and written communication skills must be coupled with experience and ingenuity in recognizing and resolving problems. Development of skills and experience is a continuous process which must be shared equally by NCUA and the examiner.

The development of a training program, including formal classroom training and a variety of experiences, is essential in fulfilling the role of the examiner. NCUA has developed formalized classroom training and an on-the-job (OJT) training program to develop examiner's fundamental skills and knowledge. Success of those programs is enhanced by the efforts made by the examiner to participate. Thereafter, the examiner is best able to determine the skills, knowledge, and experience needed to manage a district. Accordingly, each examiner should work with the Supervisory Examiner in developing a training program.

The examiner is in a unique position to learn by observing the operations of a variety of credit unions. Wide exposure to the technical knowledge and varying management styles of soundly operated credit unions helps the examiner to become an expert in the field. This expertise, which is an end product of the training process, is most useful in addressing problem credit unions.

Additional resources are available to the examiner from the credit union industry. In certain situations, the examiner may lead credit union management to seek assistance from trade associations and competent and willing credit union personnel in the area. The examiner should know what assistance is available and who will be willing to assist. Exposure to other competent management can be a valuable tool in convincing management of problems and the procedures for their resolution. Prior to discussing a credit union's problems with other parties, the examiner should obtain permission from its management team.

The basic supervisory method for ensuring the safety and soundness of credit unions is the examination. The vast majority of examiner time is spent examining credit unions. Thus, it is important that the examiner use this time to identify problem areas and to initiate corrective action. The examiner should lead credit union officials and management to resolve their own problems by giving proper guidance and by motivating them to action. Discussions during an examination can be useful in evaluating management's ability to properly manage and in developing rapport. Once credit union officials come to know and have confidence in the examiner as a professional, they will accept more readily the examiner's guidance. The examiner should strive to develop a working rapport with a credit union's management team.

A second supervisory method is the follow-up examination, which is discussed in the Supervision Chapter of the Guide. In addition, the examiner may determine that an interim follow-up is necessary to ensure the correction of severe problems which were outstanding at the completion of the examination. In this instance, the examiner would institute a telephone or on-site contact or a reporting procedure from the credit union to review the progress made in correcting the problems.

A third supervisory method is the analysis of the semiannual data submitted on the NCUA 5300, Financial and Statistical Report. From this data, the examiner can rearrange priorities to best address the needs of the credit unions in the district. The Financial Performance Reports may be used for the same purpose.

The examiner also has available administrative actions which are discussed in the Supervision and Suspension and Termination Chapters of the Guide. These are used only through the Regional Director's authority in those credit unions with severe problems where the officials are unable or unwilling to effect corrective action.

## 1.4 Workpapers and References

(1) Workpapers

a. NCUA 2049, Schedule of Contacts

(2) References

a. NCUA Long-Range Plan

## 6. Funds Management

Funds management can be broadly defined as the continuing arrangement and rearrangement of both sides of a credit union's balance sheet in an attempt to obtain reasonable profits and allow for adequate liquidity and safety. The process centers upon the short-run adjustment of assets and liabilities to compensate for anticipated and unanticipated variations in the flow of funds. In the long run, the success of a credit union depends on the ability to reconcile conflicting objectives in obtaining and utilizing funds. Funds management is often thought of as a means of providing liquidity. In this connection, liquidity means the ability to respond to loan demand and meet share withdrawal requests at minimum cost. In addition, funds management also encompasses the management of assets and liabilities to provide for an adequate net margin.

Information developed during all phases of the examination is brought together in the analysis of funds management. Maturity schedules, profitability ratios, the balance in cash and the turnover in loans are all part of funds management. The purpose of this analysis is very simply to determine if the credit union will be able to continue operating profitably and with sufficient liquidity in future periods. If there are indications that operations will be impeded, the examiner should determine the cause of the problem and work with the officials to correct it. The examiner's objectives during the review of funds management are to:

(1) Determine the degree of credit union profitability and liquidity;

(2) Assess the future profitability and liquidity position of the credit union; and

(3) Determine if credit union policies in funds management are sufficient to efficiently structure the balance sheet to meet changing economic conditions.

The examiner will record the completion of the funds management analysis on NCUA 2055, Examination Checklist.

### 6.1 Liquidity

Liquidity represents the ability of a credit union to efficiently meet decreases in shares and other liabilities and to fund the loan portfolio.

The adequacy of liquidity will vary from credit union to credit union. In one credit union, at different times, the same liquidity position may be adequate or inadequate because of insufficient risk protection or excessive cost. In addition, the identical liquidity figure could be adequate or inadequate in different credit unions. To the extent that credit unions do not have exactly the same loan and share structure, or field of membership, the liquidity needs of each credit union are likely to vary. Determination of the adequacy of a credit union's liquidity depends entirely upon an analysis of the individual credit union's:

(1) Historical funding requirements;

(2) Stability of sources of funds (shares and other capital);

(3) Stability of uses of funds (loans, investments, etc.);

(4) Anticipated future funding needs; and

(5) Options for reducing funding needs or attracting additional liquid funds.

In the absence of adequate liquidity, a credit union may be forced to sell longer term assets, with the possibility of realizing large losses, or to acquire funds under adverse market conditions at excessively high interest rates.

In designing liquidity policies, the board of directors must consider the effect future events are likely to have on funding requirements, as well as the probability of such events occuring. If management does not consider future events and design the funding structure accordingly, the credit union will be run by the dictates of the economy, rather than by management. Credit unions are affected by changes in the economic climate; however, sound financial management can lessen the effect of negative changes and accentuate positive changes.

Developing assumptions with regard to the future by forecasting or by some other appropriate method is essential to maintain adequate liquidity.

### 6.2 Brokered Shares/Funds

Reputable money brokers have provided a service to financial institutions for many years. NCUA does not object to the use of brokers to assist a Federal credit union in the placement of investment funds. In fact, credit unions can reduce operation expenses by utilizing the expertise of a brokerage firm to locate investment institutions which will best meet their safety, liquidity, and yield objectives. However, caution should be exercised by the credit union to insure that the broker is acting in the credit union's best interest and not simply seeking the highest yield, regardless of the risk.

Credit unions most frequently use brokers to place investment funds, and this activity is discussed in detail in Section 9. In addition, credit unions sometimes acquire funds through brokers. The acquisition of brokered funds is not illegal, but the purposes for which these funds are used involve unsafe and unsound practices in almost every case. This is especially true when a small credit union receives brokered deposits far in excess of its previous level of shareholdings.

In most cases, the cost of the newly acquired deposits, including the broker's fee, is above current market rates. In some cases, the credit union does not have an existing need for the funds to meet normal consumer-type loans demand; thus, to turn a profit, it is forced to reinvest the funds in either long-term or highly speculative investments or to make large,high-risk, commercial or business loans -- loans which the credit union does not have qualified personnel to process. Many times the loans are made by the credit union after the borrower has been turned down by banks, savings and loans, or others more qualified to assess the merits of such loans.

While the receipt of brokered deposits may not be illegal when the cost of the deposits is above market and the amount of the deposits is inordinately large in comparison to pre-existing shares, the credit union will either operate at a deficit or resort to unsafe and unsound practices to obtain a profit. The situation becomes irreversible once the funds have been committed to long-term or high-risk investments or loans. It is, therefore, important that acquisitions of inappropriate brokered deposits be detected as early as possible in order that supervisory actions may be taken to salvage the credit union and/or protect the Share Insurance Fund.

Examiners should be alert to detect the use of brokers by credit unions to raise operating capital. When an examiner determines that a credit union is obtaining, or attempting to obtain, brokered funds, all available information about the activity will be quickly gathered and reported by telephone to the supervisory examiner. The following list, which is not all inclusive, represents the type of information to be reported:

(1) Name of receiving credit union

(2) Total assets of the receiving credit union

(3) Total amount of brokered funds received and approximate date(s) of receipt, including the fees paid to the broker to obtain the funds

(4) Name of credit unions that have placed funds in the receiving credit union

(5) Name of brokerage firm(s) and the representatives involved

(6) Loans (or loan application) to the broker or information on loans the broker has arranged or attempted to arrange for the receiving credit union

(7) Use of brokered funds already received

(8) Names of other credit unions the officials may be aware of that are using brokers to obtain deposits.

After discussing the matter with the supervisory examiner, the examiner will discuss the damages of improper or unsafe use of brokered funds and will advise the officials that NCUA considers improper use of brokered funds as unsafe and unsound and could serve as a basis for administrative action against the credit union and possible action against the responsible credit union officials.

### 6.3 Loan Turnover Rate

The loan turnover rate is computed for examiners on the ratio analysis page of the Financial Performance Report (FPR). The estimated loan maturity in months is given for the last 5 years and for the peer group. The formula for computation of the loan turnover rate is given in Section 7510 of the Accounting Manual for Federal Credit Unions.

The loan turnover rate is a computation of the number of months it will take to roll the portfolio over. For example, if a credit union with a 24-month turnover rate adjusts its interest rates, it will require about 2 years for all of the funds currently in loans to be reloaned at the adjusted interest rate. The loan turnover rate is computed by dividing the average total dollar amount of loans outstanding for the previous 12 months by the monthly loan repayments for the same period. The loan turnover rate, in use, assumes that the future will be a continuation of the past and, thus, can never be better than an approximation. The rate cannot consider the effects of early payments, increases or decreases in delinquencies, and other such potential factors.

The loan turnover rate can be converted to a ratio for loan maturity structure purposes. The conversion is 100 percent divided by the loan turnover rate. The result is the percent of the total portfolio that will be rolled over each month. From the percent per month, the anticipated repayments can be plotted for duration of the current portfolio. Credit unions can and should use this information as part of their funds management process. Decisions to adjust interest rates and loan policies are best made when the expected results of those decisions are known and considered beforehand.

### 6.4 Regular Shares/Share Drafts

Regular shares and share drafts are difficult to categorize in terms of maturity. By their very nature they should be treated as extremely volatile capital instruments, as the credit union has limited control over their withdrawal. However, in most credit unions, there is a certain amount of regular shares that tends to remain regardless of economic or rate conditions. As a general rule (arbitrary), the following maturity schedule for regular shares may be used. Regular shares over $10,000 may be treated as having a maturity under 3 months. Regular shares under $10,000 can be divided equally in amount among the five time categories. The examiner may override any of these assumptions based on the circumstances at hand.

### 6.5 Matching Rate Sensitive Assets and Liabilities

Each credit union must develop its own strategy towards funds management. The basis for evaluating funds management strategy is through a thorough understanding of the individual credit union, its field of membership, the nature of its assets and liabilities, and the economic and competitive environment. The countless techniques developed to deal with this issue are of questionable use if they are not applied and interpreted with a full understanding of the nature of the individual credit union's assets and liabilities. No single perspective, theory, or structure can be applied universally to all credit unions, nor will any combination of approaches eliminate the necessity for the exercise of sound judgement.

Rate sensitive assets (RSA) and liabilities (RSL) are those accounts which tend to price themselves at market rates over a period of time. Loans and investments are examples of rate sensitive assets; shares and notes payable are examples of rate sensitive liabilities.

While it is not possible to forecast the absolute certainty of a mismatch occurring, weaknesses in the matching of assets and liabilities can be identified. As examples, a credit union may have most of its assets in medium term loans and investments while most of its shares are in accounts over $10,000. Since share accounts, particularly those over $10,000, have shown an increasing tendency to disintermediate, the credit union should be aware of the potential effect. There is the likelihood of the regular shares either rolling into higher priced share certificates or being withdrawn and placed with a competitor. Therefore, the credit union might be forced into higher priced share capital or into a loss of share capital and consequent illiquidity.

### 6.6 Cumulative Total Percentage

A ratio of 100 percent is a balanced position in terms of matching assets with liabilities. As the ratio rises above 100, the credit union assumes a more asset-sensitive position, i.e., assets are more liquid than liabilities for the time frame involved. Conversely, as the ratio declines below 100, the credit union assumes a more liability-sensitive position, i.e., liabilities are more liquid than assets for the time frame involved. In general terms, a credit union which is asset sensitive (+100) has more options when it comes time to make adjustments in its rate-sensitive position. A credit union which is liability sensitive (-100) is not in a favorable position in an environment to rising or fluctuating interest rates since it is difficult to adjust a liability position without incurring increased expenses or losses (the choices usually are allowing rate-sensitive liabilities to disintermediate by converting assets to allow disintermediation or by paying higher rates for the liabilities).

The larger the imbalance between rate-sensitive assets and liabilities the greater the profit or loss potential. Management should analyze the degree of risk it is willing to take as well as the degree of risk the credit union can sustain.

### 6.7 Liquidity Measure

The Cumulative Net Position and the Cumulative Total Position percentages for RSA's and RSL's under 12 months are used as measures of general liquidity for a credit union. In essence, these figures should show the ease with which the credit union can restructure its assets and liabilities within the next 12 months. Ratios below 80 percent or above 120 percent should alert the examiner to a potential problem and careful attention should be given to the credit union's funds management plans.

### 6.8 Policies

As more and more credit unions are attracting funds on a cost-competitive basis, the need for properly supervised funds management policies increases. Having sufficient liquid assets to meet loan demands or share withdrawals is no longer enough even for small credit unions. A good policy should provide for forward planning, which takes into account the unique characteristics of the credit union, management goals regarding asset and liability mix, and desired earnings and margins necessary to achieve desired earnings. Forward planning also should take into account anticipated funding needs and the means available to meet these needs. The policy should establish responsibility for funds management decisions and provide a mechanism for the necessary coordination between the different departments within the credit union.

In addition to establishing responsibility for planning and day-to-day funds management decisions, the policy should establish certain guidelines. Examples of some typical guidelines are:

(1) Limits on the percentage reliance on a particular liability category. For example, "notes payable shall not account for more than ______% of total liabilities and equity";

(2) Limits on long-term assets that are not matched with long-term liabilities. For example, "the average maturity of investments over 1 year that are not matched with like-term liabilities shall not exceed more than ______% of regular shares."

A necessary prerequisite to sound funds management decisions is a workable management information system. Reports containing certain basic information should be prepared and reviewed on a regular basis. Report formats and the content of reports will vary from credit union to credit union depending on the characteristics of each and its funds management practices and methods. However, in general, funds management reports should contain details of:

(1) Liquidity needs and the sources of funds available to meet those needs (the maturity distribution of assets and liabilities and expected funding of commitments is vital to the preparation of this report);

(2) Asset yields, liability costs, net margins, variations from the prior period and from budgeted projections (reports must be detailed enough to permit an analysis of the cause of variations);

(3) Any exceptions to policy guidelines; and

(4) Economic conditions in the credit union's area, interest rate projections, and any anticipated deviations from the originally planned budget.

Additional types of reports may be necessary depending on the credit union's circumstances. Funds management decisions must be made on an informed basis; to accomplish this, a good management information system is necessary.

Examiners should discuss funds management policies and practices during every examination on an as-needed basis.

## 6.9 Balance Sheet Structure

There are numerous tools that can be used to review the position of the credit union. Critical to any review is the relation of costs, yields, and maturities on an individual credit union's balance sheet. The examiner should become familiar with this interrelationship and be aware of the effect of different mixes of assets and liabilities. The following sample format may be used to assist in reviewing the impact of potential changes to a balance sheet.

| Account | Amount | | Yield on Assets | | $ | Yield |
|---|---|---|---|---|---|---|
| Personal Loans | $3,960,000 | x | 11.75 | % | = | $465,300 |
| Open End Loans | 1,200,000 | x | 13.25 | | = | 159,000 |
| Real Estate Loans | 700,000 | x | 9.70 | | = | 67,900 |
| Cash | 455,000 | x | .00 | | = | 0 |
| Common Trust Investments | 329,000 | x | 10.35 | | = | 34,052 |
| GNMA | 425,000 | x | 8.15 | | = | 34,638 |
| S & L CD | 100,000 | x | 13.40 | | = | 13,400 |
| Land and Building | 525,000 | x | .00 | | = | 0 |
| Misc. Non-earned Assets | 31,000 | x | .00 | | = | 0 |
| TOTAL | $7,725,000 | | 10.02<br>Weighted Average | % | = | $774,290 |

| | Amount | | Cost of Liabilities | | $ | Cost |
|---|---|---|---|---|---|---|
| Notes Payable | $ 300,000 | x | 10.00 | % | = | $ 30,000 |
| Regular Shares | 4,100,000 | x | 5.75 | | = | 235,750 |
| Share Certificates | 1,700,000 | x | 8.35 | | = | 141,950 |
| MMC | 1,200,000 | x | 10.00 | | = | 120,000 |
| Reserves/UE/Income | 400,000 | x | .00 | | = | 0 |
| Misc. Liabilities | 25,000 | x | .00 | | = | 0 |
| TOTAL | $7,725,000 | | 6.83<br>Weighted Average | % | = | $527,700 |

### Asset/Liability Structure

| Maturity | Assets | Liabilities |
|---|---|---|
| Less than 90 days | 5 % | 51 % |
| 3 - 6 months | 12 | 5 |
| 6 - 12 months | 56 | 12 |
| Over 12 months | 27 | 12 |

### Projected Operations for Next 12 Months

| | |
|---|---|
| Weighted Average Annual Yield on Total Assets:<br>(10.02% x $7,725,000) | $774,289 |
| Weighted Average Annual Cost of Capital:<br>(6.83% x $7,725,000) | $527,700 |
| Estimated Margin on Funds | $246,589 |
| Less: Estimated Operating Expenses | ($196,598) |
| Margin Before Reserve Transfer | $ 49,991 |
| Required Reserve Transfer (5%) | $ 38,714 |
| Estimated Total Operating Gain for Next 12 Months | $ 11,277 |

Using the preceding balance sheet as a guideline, estimates can be made about the effect of changes to the asset/liability structure. Below are some scenarios with their estimated effects.

Scenario 1

Credit union decides to sell a $100,000 S & L CD and uses the proceeds to make a building addition.

Effect

Income would decrease by $13,400 annually because of change from earning asset (at 13.40%) to non-earning asset. This would place the credit union into a deficit position of ($1,453).

Scenario 2

Credit union anticipates that $500,000 will move from Regular Shares to Money Market Certificates.

Effect

The cost of funds would increase by 4.25% x $500,000 or $21,250. This would place the credit union into a deficit position of ($9,973).

| | Present | Scenario 1 | Scenario 2 |
|---|---|---|---|
| Estimated Annual Yield | $774,289 | $760,889 | $774,289 |
| Less: Estimated Cost of Capital | 527,700 | 527,700 | 548,950 |
| Estimated Margin of Funds | 246,589 | 233,189 | 225,339 |
| Less: Estimated Operating Expenses | 196,598 | 196,598 | 196,598 |
| Marin Before Reserve Transfer | 49,991 | 36,591 | 28,741 |
| Required Reserve Transfer (5%) | 38,714 | 38,044 | 38,714 |
| Estimated Gain (Loss) for Next 12 Months | $ 11,277 | ($ 1,453) | ($ 9,973) |

## 6.10 Conclusions and Recommendations

After reviewing rate-sensitive assets and liabilities, and by using other previously completed data such as trends and ratios, the examiner should be able to reach conclusions about:

(1) The adequacy of the credit union's funds management policy;

(2) The ability of the credit union, based on its current asset/liability structure, to have adequate sources of funds to meet future liquidity needs; and

(3) The ability of the credit union to maintain a positive net margin in the future based on its current asset/liability structure.

## EXAMINER'S GUIDE

During the analysis of this area, the examiner should remember that the sophistication level required for funds management policies, monitoring systems, and reports is related directly to the credit union's reliance on extremely rate-sensitive liabilities (notes payable, money market share certificates, share drafts, etc.). However, no credit union, regardless of size, can ignore funds management concepts altogether and continue to remain liquid and profitable.

The examiner should be alert to any of the following deficiencies during the analysis of funds management for possible treatment in the examination report as an area of concern under the heading "Funds Management."

(1) Lack of a funds management policy;

(2) Failure of credit union employees to follow the established funds management policy;

(3) Failure to monitor funds management performance through funds management reports. This includes adjustments of budgets when necessary to compensate for variances from projections;

(4) Failure to match funds from notes payable, money market share certificates, public unit accounts, and any other share accounts that the examiner believes are volatile or rate-sensitive with like or shorter term assets with higher yields than the costs of the funds. Ideally, all of the funds in the above category would be placed in asset accounts with like or shorter term maturities;

(5) Use of rate-sensitive liabilities to fund loans that do not have variable interest rates indexed to a money market indicator;

(6) Purchase of long-term investment securities in excess of 5 percent of assets without matching the securities to stable funds (IRA/Keogh Accounts, Reserves, etc.) or establishing values at which the securities would be sold if their market values decline to predetermined levels;

(7) Borrowing funds to make loans of longer maturities than the borrowed money; and/or

(8) A negative net margin for two dividend periods or 3 months, whichever is greater.

The above deficiencies are not the only types that the examiner might encounter during the analysis of funds management. Examiners should consider all potential ramifications of the credit union's funds management policies, practices and procedures and initiate corrective action when they are, or potentially are, deficient. The plans of action developed should be very specific when the credit union's financial soundness is impaired, such as the deficiency cited in item (8) above. In addition, if management will not agree to take specific steps to correct the problem, then an administrative action should be recommended if the credit union's safety and soundness is, or will be, impaired.

When funds management is inadequate and an area of concern, the examiner may prepare supplementary facts on funds management. The comments might highlight specific deficiencies and their impact or potential impact on the credit union's ability to provide for future liquidity needs and their impact on the credit union's current and future earnings. The comments also should describe commitments from management to correct the deficiencies. Examiners also may want to include statistics, such as an estimate of the credit union's short-term funding needs and its ability to meet those needs, trends in net margins, etc. However, only statistics meaningful to the problem should be provided and discussed in the examination report.

### 6.11 Workpapers and References

(1) Workpapers

  a. NCUA 2055, Examination Checklist

(2) References

  a. Accounting Manual for Federal Credit Unions.

## 7. Management

The evaluation of quality and effectiveness of management is a major examination objective. The board of directors is the source of all authority and responsibility in a credit union and, as such, is responsible for sound policies and objectives during the day-to-day operations of the credit union. While the evaluation of the board of directors is one of the most important examination functions, it may be difficult to perform since examiners spend little time with credit union directors. The key to this evaluation is the realization that all facets of the credit union's operations reflect the ability and the interest (or lack thereof) of the board.

Management can be divided into three primary stages:

(1) Planning is the systematic arrangement of all the factors required to achieve the goals and the objectives of a credit union. During this stage the what, why, how, when, and who is determined and analyzed.

(2) Directing is the implementation stage after appropriate planning has taken place. During this stage, management ensures that a plan, project or idea is placed into operation and/or continues in operation.

(3) Controlling is the systematic review to determine that goals and objectives are being met within established policies and procedures. During this stage the results and effectiveness of the different components of a credit union are measured and revised.

Management is responsible not only for the present operations of the credit union but also for planning for the future. The past and the present are certainly significant and require an in-depth analysis of financial condition, but the determination of what management is doing about the future should plan an equally significant role in the evaluation of management. Objectives of a management review are to determine that:

(1) Officials fully understand their duties and responsibilities;

(2) Officials are discharging their responsibilities in an appropriate manner and are complying with applicable rules and regulations;

(3) Officials have developed adequate objectives and policies for all financial and operational areas;

(4) Conflicts of interest and/or self-dealing practices do not exist; and

(5) Management decisions are sound.

## 7.1 Management, NCUA 2130

NCUA 2130, Management, is an optional workpaper which may be completed during each examination. This form can be used to further emphasize the specific types of weaknesses found in a credit union's management practice.

This form also emphasized accountability: setting goals, measuring results, defining policies and procedures and evaluating employee performance. As credit unions become larger and add new staff and programs, there is a greater expectation for more professional management. Weaknesses in management should be cited as a Major Area of Concern and commented upon in the Overview section of the examination report.

Additional emphasis on this form is provided for the review and evaluation of management contracts. The examiner should be alert to overly liberal, open-ended contracts that expose the credit union to unaffordable contingent liabilities. Significant weaknesses noted should be cited in the appropriate section of the examination report dependent upon severity.

This form, when used, should be distributed to all those in attendance at the joint conference.

### 7.2 Board Minutes, NCUA 2230

The basic objective of reviewing minutes is to determine whether the board is practicing the principles of good management. An analysis of the minutes should enable the examiner to draw conclusions and to develop data for use in advising and in guiding the officials in sound management techniques. Much of the information obtained through this review can be useful to the examiner in determining the fitness of management and soundness of policies.

NCUA 2230, Board Minutes, may be used to record information during the review of director - and executive committee-meeting minutes. When a negative answer is appropriate in one of the columns on the right of the form, a check mark should be inserted. When no check mark appears, the answer will be presumed to be affirmative. The use of these columns is optional. Only major actions taken should be recorded in telegraphic style in the "Notes on Important Business" section of the form. In credit unions with complete policy manuals, a review of every month's minutes may not be needed.

If the examiner finds that minutes are missing or that those on file are incomplete, guidance should be provided to the board, particularly to the secretary. The examiner should not automatically conclude that meetings were not held because minutes are unavailable.

If the board has appointed an executive and/or an investment committee, the authority and actions of this committee should be reviewed.

In the event the examiner elects to not record pertinent actions taken by the board on NCUA 2230, a workpaper will be included in the examination report, which includes, as a minimum, the date of the board meeting and the actions taken which affect the credit union in a significant way; for example, loan rate changes, loan policy changes, agreements with collection problems, reports regarding recordkeeping, dividend policy, consideration of new programs, investments, bond changes, insurance changes, profit level changes, etc.

### 7.2-1 Membership Meetings

Membership meetings should be held in accordance with the Act and the bylaws. Membership meetings provide members the opportunity to meet and to elect officials and to partake in the credit union's operations. Credit unions should conduct the meetings in an orderly fashion and may wish to employ a qualified parliamentarian and to use Robert's Rules of Order.

Each credit union is assigned a membership code based on the make-up of its primary membership. Membership codes are maintained by NCUA to properly classify credit unions by type and to provide statistics based on that type. If the examiner determines that the membership code is incorrect, the proper code should be placed on NCUA 2230 and the regional office should be advised. A listing of membership codes can be found in NCUA 8030, Type-of-Membership Classification for Federally Insured Credit Unions.

### 7.3 Financial Management

Sound financial management requires that the board of directors considers establishing the following practices and/or procedures:

(1) Short- and long-term financial goals and objectives;

(2) An operational budget for each year (or shorter periods), with a review of each month's performance against budgeted goals with narrative analysis of significant variances;

(3) Written investment policies granting clear, precise authority to persons running this program, with a monthly review of portfolio market value;

(4) Lending policies with stated interest rates, acceptable collateral, and maximum repayment schedules;

(5) Borrowing policies, which name authorized persons, maximum amounts to be borrowed, supportive data required to justify borrowing, and reporting requirements to the board;

(6) Share capital policies, with guidelines for establishing and controlling a stable base for present and future operations;

(7) Spending policies, which include items that may be incurred without formal approval, and expenses, which must be reported to the board after the fact; and

(8) A funds management program that includes profitability and cash flow projections.

### 7.4 Personnel and Operational Management

Sound personnel and operational management requires that the board considers establishing the following practices and/or procedures:

(1) Personnel policies in writing;

(2) Written position descriptions for all employees;

(3) Written performance evaluations of all employees, including top management, at least annually;

(4) Internal audit program;

(5) Internal controls in place for all key areas of operation; and

(6) Written procedural manuals for all areas of operation.

## 7.5 Surety Bond Review

During the course of an examination, the examiner should determine that the surety bond is in force, in an amount at least equal to regulation minimums. The examiner should document in the examination workpapers the bond number, bonding company name and address, amount of coverage maximum, any deductibles, riders, and other clauses. The examiner must be alert to areas of risk where the credit union is not protected. An examination will not be completed without assurance from the bonding company that coverage is in force. For reference, the examiner should become familiar with Section 5170, "Insurance Coverage," of the Accounting Manual and Regulation 701.20. Most writers of credit union surety bonds have a Risk Management Division whose auditors will, upon request, perform an internal audit designed to detect dishonesty or other internal weaknesses. A more detailed discussion of surety bonds is contained in the Surety Bond section of the Guide.

In the event an examiner makes a discovery which may affect the bondability of an employee or an official, the details should be provided to the board of directors and an agreement obtained for immediate action. The board is responsible for notifying the insurer and the U.S. Attorney's office. A credit union is required to complete a Criminal Referral Form, NCUA 2362 whenever criminal activity is suspected. Examiners should determine this has been accomplished within the required 7 days of the discovery of the suspected activity. The regional director has the responsibility to report matters to the U.S. Attorney and to the FBI when criminal activity is suspected. Under normal circumstances, the board of the affected credit union will provide the data necessary to insure justice is served. During the examination, the examiner should determine if any criminal activity or other bondable loss has occurred and should verify that the regional office has been notified about the specifics. If the credit union has not notified the regional office, the officials should be instructed to do so immediately.

## 7.6 Summary

The examiner must be aware of the importance of management in credit unions. Poor management has a significant impact on every aspect of a credit union's operation, from the financial condition to the loan counseling procedures. A credit union's management is responsible for the effective and efficient operation of the credit union; the examiner should determine that management has accepted and acted on that responsibility. Where the officials have not met their responsibilities, the examiner should take appropriate action, whether it is instruction during the examination, a Record of Action or a recommendation for an administrative action. The examiner should never recommend the removal of credit union management or personnel to the officials except for criminal acts. Rather, the examiner's objective should be to clearly identify existing problems to the officials so that they may assign responsibility and take corrective action. Removal of credit union management and/or personnel may be one of the alternatives presented to the officials, but any removal action must clearly be the officials' decision. Removal of officials and management by NCUA can be done only in accordance with the Act and the Rules and Regulations.

## 7.7 Workpapers and References

(1) Workpapers

- a. NCUA 2130, Management
- b. NCUA 2230, Board Minutes

(2) References

- a. Federal Credit Union Act
  - 1. 110 - Members' Meetings
  - 2. 111 - Management
  - 3. 112 - Executive Officers; General Manager
  - 4. 113 - Board of Directors
  - 5. 114 - Credit Committee
  - 6. 115 - Supervisory Committee
  - 7. 206 - Cease and Desist; Removal of Officials
- b. Federal Crdit Union Bylaws
  - 1. Article V - Meetings of Members
  - 2. Article VI - Elections
  - 3. Article VII - Board of Directors
  - 4. Article VIII - Executive Officers
  - 5. Article IX - Credit Committee
  - 6. Article X - Supervisory Committee
- c. NCUA Rules and Regulations
  - 1. 701.12 - Supervisory Committee Audits
  - 2. 701.2(d) - Loans to Officials
  - 3. 701.33 - Compensation of Officials
  - 4. 711 - Management Official Interlocks
  - 5. 747 - Administrative Actions

## 8. Loan Analysis

The soundness of the credit union, its service to members, and the quality of its management can be measured in the appraisal of loans.

Objectives during a loan analysis generally will be to determine:

(1) The asset quality of the loan portfolio and the risk it represents to the Insurance Fund;

(2) The collectability of the loans in order to make an accurate appraisal of the General Ledger loan account;

(3) That policies, practices, procedures, and internal controls regarding loan portfolio management are adequate, i.e., long-term loans are matched with capital items of similar maturities;

(4) That loans are granted in compliance with applicable laws, regulations and policies;

(5) That credit union employees are operating in accordance with established guidelines; and

(6) That corrective action is initiated when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations are noted.

Asset quality, not minor exceptions, should be the main concern. A credit union with perfectly documented mortgage loans funded entirely by regular shares may have far greater problems than a credit union with an adequately matched portfolio that includes incomplete applications and unfiled liens.

### 8.1 Examination Procedures

In general, loan policies will be reviewed to ensure that the credit union has sound business planning to support this major asset account. The approval process and lending procedures will be reviewed to determine that practices are implemented as policies dictate and that reasonable internal controls are in place. Individual loans will be reviewed to the extent necessary to determine that policies and procedures are implemented as planned and to enable the examiner to appraise the loan portfolio. Procedures for the review of individual loans are discussed in subsection 8.3. The number and the type of loans reviewed will depend on the examiner's judgement. As a minimum, insiders' loans, current loans made in the last 3-5 months, commercial loans, real estate loans, and large loans and concentrations of credit should be reviewed. If the credit union is experiencing a high delinquency ratio, a high loss ratio, and/or poor collection procedures, a review of delinquent loans, and charged off loans should be included in the minimum loan review. When the above problems exist, the use of a profile of loans may be warranted with the summary of results being a part of the examiner's report to officials. Procedures for the review of particular types of loans; i.e., insiders' loans are discussed in subsection 8.4. Collection procedures will be reviewed to determine that losses are limited.

In credit unions which have serious or potentially serious financial problems, the examiner should ensure that loan documentation is adequate for those loans which are reviewed. If a lack of documentation is noted, the examiner should ensure that corrective action is undertaken during the examination or contact, since the possibility of merger or liquidation exists. If documentation of loans is lacking at the time of a subsequent merger or liquidation, the cost to the insurance fund for loan guarantees or reduced bids for the loans will result.

After the analysis of loans has been made from the planning stage through the collection program, the examiner will appraise the entire portfolio to determine its collectable value. Guidelines are provided to assist examiners in this appraisal, but the most important part will be the examiner's judgement, developed with experience and tempered with a detailed knowledge of the credit union's loan program.

The examiner will indicate the completion of the loan analysis on NCUA 2055, Examination Scope.

### 8.1-1 Loss Ratio

The Financial Performance Report (FPR) computes an annual loss ratio, termed net charge-offs to average loans, and provides a peer-group comparison. This information should be used by the examiner for both comparisons between credit unions and to supplement the examiner's trend analysis in one credit union. The loss ratio for the most recent year end will be inserted on NCUA 2110, Classified Loans. The ratio shows the amount lost per thousand dollars of loans outstanding, i.e., a loss ratio of .273 indicates that $2.73 has been lost to charge-offs for every thousand dollars that the credit union has outstanding for the period.

The loss ratio can be used for convenient comparisons between credit unions and between time periods in one credit union but, like all ratios it can be misleading. Some credit unions may have low loss ratios only because their boards are reluctant to recognize losses. The examiner should compare the loss ratios over the time periods listed on the FPR to detect trends. A high but declining ratio might indicate that past problems are being corrected. On the other hand, a credit union might have a low, but rapidly increasing, loss ratio, which might indicate an emerging problem.

The FPR will not have been distributed to examiners conducting an examination during the first 3 months of the year. In these instances, the examiner should calculate the loss ratio for the most recent year-end on a self-designed workpaper. In addition, the examiner should verify the accuracy of the information submitted by the credit union on the Year-End Financial and Statistical Report, NCUA 5300.

Instructions on calculating the loss ratio are:

(1) Determine net losses for the last full calendar year by subtracting total recoveries on charged-off loans during the year from total loans charged off during the year.

(2) Determine average loans outstanding by adding total loans outstanding at December 31 for the last 2 years and dividing by two.

(3) Calculate the loss ratio for the year by dividing net losses for that year by average loans outstanding at December 31 of that year. NOTE: Two zeros are added to the net losses to avoid excessive decimal places in the resultant loss ratio.

EXAMPLE: If average loans outstanding were $550,000 and net losses for the year totaled $1,500, the loss ratio for the year would be:

$\$150{,}000 \div \$550{,}000 = .273$

## 8.2 Loan Policies

Sound business practices require credit unions to have written loans policies designed with both financial and credit extension considerations in mind. The following financial considerations apply:

(1) Member needs. Each credit union serves a different field of membership with somewhat differing needs. An association or a community group will seldom need to become involved with stock loans, but an employee group in a company with annual stock distributions to employees will probably need such loans. Loan policies should be tailored to the membership and should be revised as membership patterns change.

(2) Availability of funds. Funding loans should be considered both from an internal and an external perspective:

a. Internal funding policy depends primarily on the credit union's liquidity. When loan demand is high and liquidity is tight, a credit union can restrict loans to those with very low risk. When a credit union cannot lend its available funds, it usually will grant higher risk loans or will invest excess funds.

b. External funding considerations involve the general return on invested funds as compared to the available yield on loans. If the yield on loans is materially greater than the available return on investments, a credit union will generally attempt to put its funds into loans. Depending on the demand, as discussed above, this could lead to granting marginally acceptable loans. When the return on investments is greater than the yield on loans, a credit union has an alternative for funds and may not consider marginal loans. Some credit unions carry this too far and effectively stop granting loans, a departure from the basic purpose for credit unions.

(3) Competition. A credit union needs to be aware of what other national and local lenders offer to its members. Banks and automobile manufacturers can often accept higher risks on a per-loan basis and, thus, take loan business away from a small credit union.

(4) Cash fow. Loan policies must be tied into the credit union's overall funds management program and must provide for cash flow as well as a profitable return. Single payment loans and balloon notes should be considered very carefully from both the likelihood of repayment and the negative effect on liquidity that such loans have.

## EXAMINER'S GUIDE

The following credit extension considerations apply:

(1) Adequate borrower information. Only with complete and accurate information will the credit committee or the loan officer be able to appraise the applicant's willingness and ability to pay. The Act, Bylaws and Rules and Regulations require the credit committee to appraise these credit qualifications. The applicant's income, source and stability of income, and obligations should be documented on a completed loan application. Additional data request on most loan applications not only provide information to aid the credit committee or the loan officer to make a sound decision but also may be helpful if collection activity is needed.

(2) Terms of repayment. Loan repayment terms should be based upon the applicant's ability to pay, the purpose of the loan, the collateral accepted and the conditions existing in the credit union and in the community. They also should be consistent with the provisions of the Act and Rules and Regulations.

(3) Collateral. The Credit Manual discusses collateral and the actions to be taken by the officials when accepting collateral for various types of loans. Certain principles which should be followed are:

a. Equity in the collateral should be sufficient so that the applicant will not give it up easily.

b. Repayment schedules should be established so that the loan balance will be reduced more rapidly than the collateral will depreciate.

c. Collateral should be readily convertible to cash.

d. Collateral should have a known value. For some types of collateral, such as vehicles, the credit union can determine the value from publications designed for that purpose. Other types of collateral, such as real property, should have a written appraisal to document its value. When comakers are accepted, comaker statements should be on file which provide the same information asked of the loan applicant. An acceptable comaker must have the ability to repay in case the borrower defaults.

(4) Extension agreements and refinanced loans. The principles of credit discussed in this section also apply to the use of extension agreements and refinanced loans. They should not be used as devices to cover up delinquency problems.

(5) Chattel lien instruments. Whether a credit union files chattel lien instruments, purchases chattel lien non-filing insurance, or does neither is a management decision. However, it is also management's responsibility to see that the credit union is protected, and that it complies with the provisions of state and local laws. If adverse experience has occurred on chattel lien loans, the officials may need to adjust their policies and procedures.

Examiners should record the credit union's current loan policies on NCUA 2255, Loan Data Sheet, or attach a copy of the credit union's written loan policies to the workpaper.

## 8.3 Approval and Lending

The examiner can analyze and appraise the credit committee/loan officer's procedure and the quality of loan service through a review of the records of the board, credit committee and/or loan officers.

The manner in which the credit committee/loan officers function and the practices they follow can determine the effectiveness of loan service. Some considerations in the appraisal of loan service are:

(1) Are borrowers treated respectfully and are their transactions kept confidential?

(2) Are loan services reasonably prompt? Are legitimate emergencies handled expeditiously?

(3) Are loan limits realistic? To the extent that funds are available, are the loan limits geared to make as wide a range of service as possible available to the entire membership?

(4) Are collateral requirements reasonable? Do these requirements provide adequate protection to the credit union?

A special meeting should be held with the credit committee and/or operating personnel if the interests of the credit union are materially affected by:

a. Detrimental lending policies and practices;

b. Faulty credit committee/loan officer practices; and/or

c. Faulty loan processing procedures.

When any of these conditions prevail, the examiner should work with the credit committee and/or loan officers to formulate plans of action to correct the areas of concern.

Credit committee and/or loan officers' actions should not exceed their authority, and the board should exercise adequate monitoring and control over their approvals of loans.

### 8.3-1 Credit Reports

Many credit unions of all sizes use credit reports as a part of their evaluation of creditworthiness. Credit reports are received either as a printed form or orally over the telephone. The forms usually become part of the permanent loan file and are available for review. Oral credit reports are often faster and less expensive, especially for smaller credit unions, but are subject to misinterpretation and often are not noted in the borrower's loan file.

An example of a TRW credit report, with explanations, is included at the end of this section. TRW is one of many companies which provide credit reports, all use different codes. Examiners should become familiar with the type of credit reports used by the credit union being examined. (Use of the TRW credit report as an example should not be construed as an endorsement of the company.)

## 8.4 Individual Loans

Individual loans should be reviewed to the extent necessary to determine that policies and procedures are implemented as planned and to enable the examiner to appraise the loan portfolio. Although the loan portfolio is not mirrored in each individual loan, the individual loans can form a pattern with distinctive characteristics. When lending problems are not found, examiners may want to review recently granted loans to ensure, to the extent possible, that problems are not developing. When material problems are found in the lending program, examiners should profile the loan portfolio to determine its patterns and characteristics with the goal of advising management of the specific steps necessary to correct the problems.

The credit committee and/or loan officers' records can be used to select recently granted loans, when loans are reviewed. The balance and a reference can be listed. When the portfolio is to be profiled, the loan trial balance or print out can be used as the reference point. NCUA 2270, Loan Profile, can be completed when loans are profiled. Guidelines for completing the form are on its reverse.

When the total number of loans in the portfolio exceeds the number to be reviewed or profiled, a random sample can be selected as discussed in the next subsection. Where practical, the examiner can tactfully solicit the aid of operating personnel for the pulling and filing of loan documents and ledgers. Such aid should be sought after clearance from the responsible supervisor is received.

Certain other loans should be reveiwed in addition to the minimum review defined in section 8.1. These incude any of the loan types described in sections 8.5-1 through 8.5-13 if the credit union began granting, or had problems with, during the examination period.

## 8.4-1 Random Sample Procedures

A random sample is a sample in which each loan in the population to be sampled has an equal chance of being selected. The advantages of this sampling technique are:

(1) The sample result is objective. All types of loans have an equal chance of being selected; and

(2) The sample plan is uniform. Uniformity in the selection of loans provides the opportunity to combine and study sample results with a compatible base on regional and national levels.

Conducting a systematic sample with a random start can be accomplished as follows:

(1) Determine the number of loans outstanding.

(2) Determine the number of loans to be selected.

(3) Divide the total loans outstanding by the number of loans to be selected.

(4) The results of (3) above will be the sample interval, commonly referred to as the "nth" loan. Once the sample interval has been established, the loans to be included in the sample become ever "nth" loan. This is accomplished by counting "n" loans after the first one selected, then the next "nth" loan, then the next, etc.

(5) To locate a starting point, refer to the Table of Random Digits at the end of this section. Select a digit from the table (point at a number with a pencil tip). The number pointed to is the starting point.

As an example of this procedure, assume that 20 loans are to be selected from 500 loans. Divided 50 by 20; the result is a sample interval of 25. Select a random number from the table. Assume number 5 is selected. The first loan to be selected would be loan number 5 on the print-out or tape, the second loan would be number 30, then loan 55, etc., until all 20 loans to be sampled are selected.

### 8.4-2 Loan Profile, NCUA 2270

NCUA 2270, Loan Profile, may be used to document the data obtained from the individual borrower's loan file. The workpaper has been designed to be as flexible as possible, to permit the examiner to vary or adjust the data as conditions may differ from credit union to credit union. For the most part, the Loan Profile workpaper is self-explanatory. However, for purposes of uniformity, guidelines are listed on the form.

At the examiner's option, the most common characteristics of current loans and delinquent/loss loans may be summarized on a self designed workpaper. The examiner may also compute a ratio of the "most common" and "second most common" characteristic of the number of loans reviewed.

In addition, common characteristics may be summarized by amount at the examiner's option. To find the most common characteristic by amount, total the unpaid balances of the current loans profiled. Then total the unpaid balances for all loans with the same characteristic. These two totals would then be divided to obtain the percentage of occurrence for a characteristic by amount. For example, assume the total unpaid balances of current loans profiled is $100,000 and the unpaid balances of current loans with signature as collateral is $40,000. Based on amount, the frequency of occurrence for signature as collateral is 40 percent.

This Summary can show the examiner comparisons between current loans and delinquent/loss loans in summary form. If the summary indicates that the credit union has an excessive amount of high risk loans in relation to the reserve structure of the particular credit union, the examiner may need to work with the officials to develop appropriate plans of action to correct the adverse, or potentially adverse, condition. The workpaper can be used to support the need for corrective action and can be a source from which to build corrective plans.

## 8.5 Loan Types

The following subsections discuss particular types of loans granted by credit unions. When determining the scope of the review of a particular type of loan, the following conditions should be considered.

(1) The financial condition of the credit union;

(2) Whether the loan type was first granted during the examination period;

(3) Whether problems with a loan type were revealed during the previous examination or most recent audit; and

(4) Whether loans of a particular type were reviewed during the previous examination.

When an examiner becomes aware of loan concentrations, real estate lending, or commercial lending he or she should make the following additional considerations and expand the scope as applicable:

1. Does the dollar amount of loans to any one individual, group, or family member exceed 10% of statutory reserves?

2. Does the dollar amount of commercial loans exceed 50% of statutory reserves?

3. Does the total amount of any of the above types exceed 20% of the total loan portfolio?

### 8.5-1 Large Loans and Concentrations

When reviewing loans, the examiner may find large loans or concentrations of credit to individuals or among such affiliated groups as family members, partnerships or closely allied persons. For purposes of definition, a large loan or concentration of credit is considered to be the greater of $50,000 or 10% of the credit union's statutory reserves. In the event no loans or concentrations fall within this definition, all loans $200,000 and over will be reviewed. A sufficient number of such loans and concentrations should be reviewed by the examiner to determine that sound policies and practices are being followed in approving and processing such loans. In all cases the concentrations will be listed on NCUA form 2300, loan concentrations or an equivalent self designed workpaper. Such loans could violate a basic principle of sound credit extension, i.e., risk diversification. Other factors noted during the loan review process could prompt the need to lower the definition of a concentration. Examiners will also want to consider the Bylaw standards which are:

> "When funds are not available to make all the loans for which there are loan applications, preference shall be given, in all cases to the applications for smaller loans if the need and credit factors are nearly equal." (Article IX, section 8 of the Bylaws.)

Prudent lending practices must be followed in order to protect the credit union from large losses. Independent appraisals should support the value of collateral, and when applicable, commercial financial statements should be obtained to support the borrower's ability to repay. However, examiners should use caution when relying on appraisals. Numerous instances have been observed in which market values and appraisal values differed by material amounts.

NCUA 2280, Large/Real Estate Loan Profile, is an optional form that can be used to document the examiner's review. Each characteristic is important and should be considered when determining if the loan is sound. The examiner may record additional statistics on the workpaper as applicable. The workpaper is for the most part self-explanatory; however, for the sake of uniformity, guidelines are on its reverse.

### 8.5-2 Insiders' Loans

Loans to officials, key management employees, and members of their immediate families must be carefully analyzed to detect any preferential treatment or abuses of sound lending practices. In analyzing insiders' loans, the examiner should determine compliance with the Act, Rules and Regulations, and Bylaws and with sound principles of internal control. The examiner should utilize the standard workpaper, NCUA 2285, Insider Loans, in scheduling all loans of this type.

In addition to a review of the loan files, the applicable Share and Loan ledgers of some or all of the insiders can be reviewed for apparent propriety of the transactions. If large, numerous, or unusual transactions appear on these records, they should be checked further as deemed appropriate by the examiner. See section 12.5 for more information on insider dealings with officials.

### 8.5-3 Lines of Credit

A line of credit is a fixed amount which may be drawn upon from time to time and which may be replenished by repayment of amounts previously drawn. The agreement between the credit union and the borrower specifies the amount that may be borrowed from time to time and the conditions of the agreement. It may be cancelled upon notice by either party. Cancellation would not relieve a borrower from repaying funds borrowed under the terms of the agreement prior to its cancellation.

A member wishing to establish a line of credit completes an application. Periodic updates are not required, but would be in the best interest of the credit union. Sound lending principles dictate that a credit union must obtain information concerning the member's total obligations to other parties at the time of the review. Also, information should be obtained concerning current income and the borrower's repayment records on other debts.

A single line of credit agreement may permit access to the line by as many different methods as a credit union's board of directors determines to be appropriate and feasible. An existing line of credit agreement may have additional methods of access added to it at a later date if the agreement is amended to accommodate the additional methods. The following is a discussion of some of the different methods of access.

(1) Check or cash disbursements are common teller transactions. Many credit unions accept telephone or mail requests. A copy of the completed request form is sent to the borrower with the check for the advance. The check used with a telephone transaction should bear a special restrictive endorsement using wording similar to:

> "Endorsement of this check by member acknowledges receipt of proceeds resulting from the transaction and agreements set forth on the detachable portion of this check and constitutes acceptance of the conditions of the agreements, which are hereby incorporated by reference."

[illegible]) Automated Teller Machines (ATM) are increasingly being used by credit unions, either as wholly owned or shared equipment. The credit union issues plastic cards which the members insert into the ATM. At the time of card issuance, the automated teller system is programmed to reflect specific information about the accounts accessed by the cards. In addition to the plastic card identification, each member is assigned a Personal Identification Number (PIN) which is used for further identification.

In order to obtain a loan advance from an ATM, the member inserts the plastic card and keys in the appropriate PIN. The ATM will verify the card and request the member to identify the amount of the advance. The machine will process the request and provide the funds requested, a receipt and a record of the transaction.

Posting of the member's loan account will occur immediately if the automated teller is real-time, on-line or at the end of each day if the credit unions uses batch processing.

(3) Loans to clear share overdrafts are granted by many credit unions using share drafts as an additional service.

At the time a credit union receives a share draft which overdraws a share draft account, the draft is accepted and the overdraft is cleared by an advance from a line of credit. The line of credit ageement should be separate from the share draft agreement. Authorization may be included in the share draft agreement for the credit union to transfer the amount of loan advance to the share draft account by using wording similar to:

> "In the event that any of the undersigned writes a share draft which would result in this share draft account being overdrawn, and if at that time any of the undersigned are eligible to receive advances from this credit union under the loan account referred to above, that share draft shall be deemed to be a request to the credit union for an advance under such loan account (in multiples of $____________) sufficient to permit the credit union to honor such draft and credit the advance to the share draft account."

(4) Loan drafts may be issued as books of loan drafts which are used by members when they access their line of credit account. The drafts look very similar to a bank check. They are specially encoded in the Magnetic Ink Character Recognition section at the bottom of each draft to allow the draft to travel through the bank clearing system to the credit union's bank for payment.

Members use the drafts by making them payable to the merchant or organization providing the desired goods or services. Interest is charged only on the amount of drafts which have been negotiated starting when the drafts are cleared by the credit union's bank.

Each loan draft is considered to be an application for an advance. A loan draft issued to a member carries with it the intention of the member to apply for a loan each and every time it is used. A share draft, on the other hand, carries the member's intent to withdraw shares each and every time it is used. A share draft may create an overdraft in a share draft account and the credit union may honor the share overdraft under a preapproved line of credit but this action does not change the share draft into a loan draft.

(5) Credit cards are similar to loan drafts except that instead of using a check, the member uses a plastic card. Credit unions usually enter into an agreement with a bank to issue "VISA" or "MASTERCARD" cards to their members for processing against the members' lines of credit.

NCUA 2270, Loan Profile, may be used to document the examiner's review. NCUA 2290, Line of Credit - Credit Cards, is an optional form which contains questions that should enable the examiner to determine if the credit union is in compliance with the Rules and Regulations and sound business practices.

### 8.5-4 Open End Loan Plans

Generally, a member wishing to participate in an open end loan plan completes a personal and credit information sheet. The personal and credit information sheet looks very much like an application for a loan, except that usually it does not ask for either an amount or a purpose. The applicant also completes and "open end" type note, often combined with the consumer credit disclosure, in which the applicant promises to repay advances made under the open end loan plan.

When an applicant desires funds, a request voucher is completed. The request voucher may be mailed or telephoned to the credit union. If the applicant's signature is not on the request voucher, an open end endorsement should appear on the check acknowledging the advance under an open end loan plan.

The primary difference between a line of credit and an open end loan plan is that advances are pre-approved under a line of credit. Advances may not be pre-approved under open end loan programs; each advance must be approved by a loan officer or the credit committee.

Each advance should be supported by a written application which includes at least: the amount requested; terms of repayment; and provisions for credit committee or loan officer approval.

The examiner should analyze the practices followed by the credit union and should review a representative group of members' loan ledgers and documents to determine how the service is being used. NCUA 2270, Loan Profile, may be used to document the examiner's review. For example, is it the practice of the members to keep their loan balances at or near the maximum permitted by the plan, thereby possibly overextending their capacity to repay and restricting their credit needs in case of emergencies? Are the members generally using the plan within the purposes intended by the board? Is it another means, when related to other loans of the members, to permit pyramiding their indebtedness? Any adverse trends or serious violations in the open end loan plan should be brought to the attention of the board for prompt correction. If significant exceptions are found in reviewing the forms and procedures they also should be discussed with the officials and commented upon in the examination report as appropriate.

### 8.5-5 Commercial Loans

Commercial loans are generally defined as loans which have any of the following characteristics:

1. Repayment will be made from business revenue;
2. The security is a business asset;
3. The purpose is to obtain a business or business asset; or
4. The proceeds will be used to finance business operations.

Commercial loans are generally not identified as such in a credit union. They may be included in secured or unsecured categories and can be for short or long term periods. Identification of these loans will, therefore, require investigative techniques on the part of the examiner. Discussions with the management team and/or appropriate loan officers is highly recommended. Commercial loans include working capital advances, term business loans, agricultural credit and loans to individuals for business purposes.

Working capital or seasonal loans provide temporary capital in excess of normal needs. They are used to finance seasonal needs and are repaid at the end of the cycle by converting inventory and accounts receivable into cash. Such loans are normally unsecured; although recently, more working capital loans are being advanced with accounts receivable and/or inventory as collateral. Firms engaged in manufacturing, distribution, retailing and service oriented businesses use short-term working capital loans.

Term business loans are normally granted for the purpose of acquiring capital assets such as plants and equipment. Term loans involve greater risk than do short-term advances because of the length of time the credit is outstanding. Because of the greater risk factor, term loans are usually secured and may require amortization. Loan agreements on such credits normally contain restrictive convenants during the life of the loan.

An increasing number of credit unions have been found to be active in this type of lending. These loans are often large and it has been found that many credit union personnel lack expertise in this area. Consequently, they can have a serious adverse impact on a credit union. In cases where commercial lending is prevalent, examiners are required to contact their supervisor who will then determine whether or nor additional expertise will be called upon. The emphasis in underwriting such loans shifts from the individual, as with a consumer loan, to the financial soundness of the business requesting the loan. Such analysis should be supported by commercial credit reports (Dun and Bradstreet, for example), analysis of the income and expense statements, cash flow and balance sheet analysis. Cash flow is major problem for most small business. Since commercial loans normally are made for a short period of time, the loan officer should document what resources of the business will be used to repay the loan. Considering the high percentage of new businesses that fail, additional collateral should be required by the credit union if it is financing a new business. If inventory is taken as collateral, all the procedures discussed concerning floor plan loans would apply. However, it must be recognized that the forced sale value of inventory in process may be only a fraction of the value of the finished product.

The examiner should be alert for insider dealings in connection with comercial loans. If officials or employees have an interest in the business, the examiner should consider whether or not the transaction violates the Rules and Regulations pertaining to loans to officials.

Farm loans are a common type of commercial loans granted by credit unions. A credit union making farm loans must take into account various factors that may not be present in considering urban real estate as security for loans. Loans are made not on acreage alone, but upon the productivity of those acres. Erosion and wastage as well as fertility must be studied since the loan may be repaid over a long period of time. The credit union must look to the productivity of the farm over a series of years as the source of repayment since it must first provide a living to its owners. The lender should make sure that there will be enough left to pay taxes and operating expenses, including reasonable allowances to maintain the productivity of the land, and still leave a balance of income from which the mortgage can be amortized. Even a well-operated small farm might be a poor lending risk because of the absence of a debt-paying balance of income.

As a business person seeking a business loan, the farmer must be able to demonstrate managerial efficiency. Operating costs should be consistent with a productive unit of the kind that a borrower should offer as security for a loan. Some farms are operated inefficiently because their owners or operators economize too much in the use of labor-saving machinery; others lean in the opposite direction and are burdened with more mechanization than the particular farm can support.

To an increased extent the farmer is required to keep accounting records of operations. When the owner of a farm makes an application for a loan, the owner must be in a position to tell what is owed. The owner's net worth should be considered when determining borrowing capacity, however, one must remember that only cash pays debts. The credit union must know in detail the current condition of the business and also the progress of the operations as compared with those in preceding periods. An increase in assets or a decrease in debts indicates an increase in net worth. The opposite tendency in either would speak against an extension of too much credit to the applicant for a loan. Changes in prices levels are taken into account in measuring changes in net worth. The examiner must temper values assigned to assets as this is the source of net worth. Most assets have more value to the borrowers than to the market.

In some respects, an income statement is even more useful in measuring debt paying capacities than is a balance sheet. The latter is somewhat of a liquidation measure; the former tests the farm operation as a going concern. Adequate and accurate income statements for farm operations are more rare than balance sheets, but they are becoming more common. County extension agents are rendering worthwhile service in encouraging account records.

### 8.5-5.1 Commercial Loan Policies/Practices

The credit union's internal controls, policies, practices and procedures for making and servicing commercial loans should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. The following considerations apply to the commercial loan review:

1. Has the Board of Directors adopted written Commercial /Agricultural loan policies that address the risk to the credit union? At a minimum the policies should:

    A. Define the trade area of the credit union: Sound commercial lending practices include regular on site inspections of collateral. Lendors must also monitor changes in the industry.

    B. Limit the Credit Union's risk by placing a total dollar limit on commercial loans (i.e., for example 10% of the portfolio), placing a limit on individual borrowers, and by placing a limit on the amount of commercial loans to be placed in any one specific industry.

    C. Define accounting standards: Prudent Boards will limit accruals of interest on commercial loans over 30 days past due. Accounting policy should also address recognition of income from points charged.

    D. Discuss repayment and purpose: For example, Christmas inventory purchases should not have a 12 month pay out.

    E. Require a watch list: Because of the risk associated with commercial loans, Boards should monitor payment status monthly by requiring monthly status reports.

    F. Identify undesirable loans: Examples might include loans for speculative purposes, loans secured by assets for which there is a limited or depressed market, loans to unprofitable business, etc.

    G. Define credit standards: Policies should address the frequency of updating financial information and require periodic audited financial statements.

    H. Define Loan pricing: The policy should address the rate needed to cover operating overhead, cost of funds, and required reserves. Policies should also address points to be charged, requirements for draft accounts, and savings requirements.

    I. Define proper documentations: Common oversights include incomplete loan applications, no payout schedules, no financial statements, no supporting schedules for investments, accounts payable, profit projections, and cash flow projections. This area should also require regular on site inspections of collateral, some testing of asset values listed by borrowers, and collection of data on economic conditions affecting the borrowers' industry.

J. Address training needs: Policies should provide for ongoing training of the staff.

K. Address the risk associated with the collateral: Strict limits must be in place on business collateral. Business assets are often appraised based on the ongoing concern concept and consequently once that business fails the values change. There is often no market for the remaining assets.

2. What expertise is available in the credit union to make commercial loans? Examiners exposed to commercial lending will document the credentials and qualifications of the credit union's commercial lending staff.

3. Does the credit union review commercial loan policies at least annually? Lending in depressed industries should be prohibited. Some factors which examiners must consider when evaluating the strengths and weaknesses of commercial loans include:

A. The borrower's cash flow: Examiners must keep in mind that only cash pays off loans.

B. The borrower's net worth: This is, of course, the borrower's cushion before he becomes bankrupt or insolvent. Net worth can easily be distorted by overstating assets or understating liabilities. The borrower's intangible assets such as goodwill, organization expense, and patents will have no value to the credit union.

C. Business profitability: One measure of profitability is net worth divided into net profit with the result being the owner's return on investment. Examiners must keep in mind that profits can be distorted by inflated receivables, improper accruals, and by the fact that financial statements might not reflect owner's draws for personal living expenses.

D. Working capital: Working capital is the difference between current assets and current liabilities.

E. Equity: Prudent lending requires the owner to have more equity in assets than the creditors.

Some internal control considerations include:

1. Is the preparation and posting of subsidiary commercial loan records performed or reviewed by persons who do not:

a. Issue official checks or drafts singularly?

b. Handle cash?

2. Are delinquent account collection requests and past due notices checked to the trial balances that are used in reconciling commercial loan subsidiary records with general ledger accounts, and are they handled only by persons who do not also handle cash?

READEX FICHE

3. Are inquiries about loan balances received and investigated by persons who do not handle cash?

4. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not handle cash?

5. Is an overdue account report generated frequently?

6. Are any independent interest computations made and compared or tested to individual interest records by persons who do not:

    a. Issue official checks or drafts singularly?

    b. Handle cash?

7. Does the credit union have an internal review system that:

    a. Re-examines collateral items for negotiability and proper assignment?

    b. Tests check values assigned to collateral when the loan is made and at frequent intervals thereafter?

    c. Determines that loan payments are posted promptly?

8. Are collection notices handled by someone not connected with loan processing?

9. Are payment notices prepared and mailed by someone other than the loan teller?

10. Concerning livestock loans:

    a. Are inspections made at the inception of credit?

    b. Are inspections properly dated and signed?

    c. Is the condition of the animals noted?

    d. Are inspections required periodically as determined by type of livestock loan?

11. Concerning crop loans:

    a. Are inspections of growing crops made as loans are advanced?

    b. Are disbursements closely monitored to assure that the proceeds are channeled into the farmer's operation?

## 8.5-6 Mortgage Loans

The degree of risk in a real estate loans depends on the loan amount, interest rate, value of the property, ability of the borrower to repay, the local economic climate, and other special terms. To protect the credit union from large losses, the officials must have established lending policies and practices that comply with the provisions of the Rules and Regulations, as well as sound business practices.

Real estate lending relies heavily on collateral and is generally though to be risk free. While this may be true in some markets, i.e., those that are appreciating, there have recently been instances where markets have collapsed. Therefore, reliance on collateral is speculative and risky. Therefore, policies should address maximum amounts to be invested in this area.

Real estate loans may be profiled on NCUA 2280, Large/Real Estate Loan Profile. Before engaging in long-term real estate lending, the credit union's management should carefully analyze the credit union's financial condition and determine the portion of its share capital and liabilities that can be committed to a long-term investment in the form of real estate loans to members.

The method in which a Federal credit union can serve the home financing needs of its members is through the secondary market. The secondary market refers to investors who purchase mortgage loans either for their own portfolios or for the assembly of mortgage backed securities. Common acronyms in the secondary market are Fannie Mae, Freddie Mac and Ginnie Mae. These are acronyms for the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation and Government National Mortgage Association, respectively. The secondary market also includes insurance companies, pension funds, mutual savings banks, savings and loan associations and private investors. Under a secondary market arrangement, the credit union would obtain a commitment from an investor to purchase mortgage loans. The credit union would then originate mortgage loans according to the specifications of the investor, sell the closed mortgage loans (in whole or in part) to the investor and service the loans for the investor. Servicing involves four major operations:

(1) Processing of Payments. The net proceeds after retaining taxes, mortgage insurance, hazard insurance, and servicing fees are remitted to the investor. The servicer is expected to handle escrow accounts and to pay taxed and insurance premiums when they are due.

(2) Protection of Security. The servicer is expected to periodically inspect the property to make sure that it is not being subjected to waste or unusual depreciation.

(3) Recordation. When the property changes hands and a new owner assumes the mortgage, a whole series of records must be changed and recorded. In the case of a mortgage insured by FHA or guaranteed by VA, the proper government agency must be notified and the required government forms must be completed.

(4) Collection. The servicer is expected to take all collection steps including foreclosure if necessary.

The normal monthly servicing fee is one-twelfth of three-eights of 1 percent of the unpaid mortgage balance. For example, if a mortgage balance was $100,000, the monthly servicing fee would be $31.25 ($100,000 times .00375 equals $375.00 divided by 12 equals $31.25). A problem that credit unions may encounter in this area is convincing a secondary market investor that they have the expertise and proven track record to service mortgage loans. The alternatives to dealing directly with secondary market investors are for a group of credit unions to form a Credit Union Service Corporation or to establish a business relationship with a mortgage lender as provided in the Rules and Regulations.

If a credit union is originating mortgage loans for its own portfolio, it assumes earnings and liquidity risks in addition to the normal credit risks.

The earnings risk that has plagued many savings and loan associations occurs when the credit union commits itself to a given interest rate for a long term (i.e., 30 years). When interest rates in the economy in general exceed the credit union's expectations, the credit union could be in a position of having its cost of funds exceed its rate or return on mortgage loans. This risk can be shifted to the borrower by making the loan a variable rate mortgage. However, the risk cannot be shifted to the borrower entirely since not all borrowers will have the financial ability to assume such a risk. The result could be an increase in foreclosures.

The liquidity risk can be lessened but not eliminated entirely by being aware of the secondary market underwriting requirements and originating loans that meet such criteria. However, a credit union could be faced with large discounts in its mortgage loans if its expertise in this area was questionable and if the interest rates on the mortgages were below market. Underwriting is the process involved in evaluating a loan's risk by analyzing the loan application submitted by the borrower and by evaluating characteristics of the property.

Some commonly employed guidelines in underwriting a mortgage loan are as follows:

(1) Total monthly mortgage payments generally should not exceed 25-28 percent of the borrower's gross monthly income.

(2) Total monthly mortgage payments plus installment obligations should not exceed 33-36 percent of gross monthly income (any installment obligation which will be paid in full in 10 months or less would be excluded from the calculation).

In evaluating this area, an examiner should consider the overall effect that the mortgage loan program is having on the financial condition and funds management program of a credit union in addition to determining that the loans comply with the requirements of the Rules and Regulations.

Following are possible unsafe and unsound operating policies and practices:

(1) Modifying or refinancing loans to prevent them from becoming delinquent;

(2) Granting additional advances to borrowers and using the loan proceeds to bring delinquent loans current. This practice may compound the initial problem and delay the eventual acquisition of security properties. When finally acquired, book values of these properties often exceed original market values;

(3) Carrying loans in the portfolio with appraised losses without recognizing these losses by establishing sufficient offsetting reserves. This results in a false statement of financial condition; and

(4) Refusing to recognize and deal with substandard asset problems, and failing to revise lending policies and practices that have resulted in substandard assets.

### 8.5-6.1 Home Equity Loans

A loan type gaining wider acceptance in credit unions is the Home Equity Loan Plan. This is at least partially attributable to the marketing of this type of loan plan by other competing financial institutions.

Home equity loans are designed to allow the borrower to make use of the portion of equity in his/her residence to increase borrowing capacity. Equity in a residence can be generated by a larger downpayment at the time of purchase, the effect of payments made over the life of the loan or by increases in the value of property due to inflation. Home equity loans can either be first or second mortgage loans. Other lenders will go as far as to make third or fourth mortgages. Credit unions are not legislatively prohibited from these practices, however, safety and soundness issues must be considered if these are more than rare occurances.

Although credit unions should employ the same procedures and evaluation of creditworthiness and collateral as in other real estate lending, home equity loans are different from the standpoint that these are often open-end loans. Advances can be generated in a variety of way, as with any open end loan plan.

Credit unions should have extensive policies on this type of loan and should employ similar procedures as with traditional real estate loans. This should include policies on the maximum percentage of appraised value that will be loaned (this should include the unpaid balance of the first mortgage plus the maximum loan limit on the second mortgage), proper and accurate appraisals of the collateral and detailed evaluation of the applicant's ability to repay, determination that compliance is achieved with all consumer regulations impacting this type of lending and that the loan and mortgage documents are correctly prepared, signed, and filed.

Advantages to credit unions of this type of loan plan include the facts that these loans are often granted at variable interest rates, are secured by collateral that can appreciate rather than depreciate, can be made with relative ease of disbursement after all initial documents are prepared and can be modified depending on the other external factors such as loan demand.

Disadvantages include the fact that real estate can and, in many places, has declined in value, that real estate must be maintained and that large losses have taken place where credit union management did not implement proper policies and/or practices in initiating this type of lending. In addition, if this type of credit is used arbitrarily, it can have the impact of overextending the borrower, increasing the risk of bankruptcy losses, especially if applicants use this credit to supplement their income. In addition, this type of lending generally contributes to a lower loan turnover rate and must be managed from a liquidity and funds management viewpoint.

The Examiner's review should focus primarily on the adequacy of the appraisal, the amount loaned plus the unpaid first mortgage in relation to the appraisal, the creditworthiness of the applicant and the impact on funds management. The review should also determine how management monitors and controls the program and evaluation of their objectives in the initiation of this program.

### 8.5-7 Floor Plan Loans

Floor planning is a specialized form of lending with above normal risks which requires specialized expertise. Very few credit unions engage in floor plan lending since they lack expertise in this area. To compensate for the risks involved, most commercial lenders charge 2 or more percent above the prime rate.

Floor plan lending is a form of wholesale or more inventory financing which is used to finance items such as automobiles, mobile homes, boats, large home appliances, furniture, and television and stereo equipment. Under a written contract between the credit union and the dealer, each loan advanced would be made against a specific piece of collateral. As each piece of collateral is sold, the contract would require that the dealer repay funds advanced for the collateral sold. A common policy requires dealers to invest 10 to 20 percent of their own funds. This type of financing usually involves the use of a trust receipt. The written contract between the credit union and the dealer specifies that the credit union will release to the dealer title to a specific piece of collateral sold and that the credit union will hold title to such collateral in trust until the time of sale. The contract usually provides that the dealer will have the right to sell the inventory, but normally at not less than the "release price." The credit union should be authorized to periodically inspect the inventory, examine the dealer's records, and upon any default by the dealer to declare a forfeiture of the dealer's interest in the inventory.

In order to reduce the risk involved in this type of financing, the credit union should ensure prompt repayment by frequently inspecting the dealer's inventory to determine exactly which units have been sold. The credit union should have records of the dates the inspections occurred, who performed them and an itemized listing of collateral. Floor plan financing should also provide for partial repayments on unsold inventory. One frequently used method is to require the dealer to reduce the invoice price by 10 percent after another 90 days have elapsed, and then require a 5 percent monthly partial payment thereafter. Under such a plan, the credit union would require that a note be paid-in-full for any units that have not been sold after 1 year. This plan encourages inventory turnover and can help the credit union avoid financing out-of-date inventory.

The credit union should require periodic financial statements from the dealer to determine that the dealer is not over leveraging his financial position. Most frequently, problems occur when a dealer is floor planning inventory with several lenders and the proceeds from the sale of the inventory is used for purposes other than to repay the floor plan loan.

### 8.5-8 Participation Loans

Federal credit unions may participate with other lenders in loans to credit union members subject to the provisions of the NCUA Rules and Regulations. While the regulations do not limit participation loans to real estate, these are normally the type of loans granted under this authority. If a credit union lacks experience in mortgage lending, a participation loan may provide additional security to an investor since the credit union would share in a portion of any loss.

When a credit union sells an interest in a loan that it has on its books, the financial community would term the transaction as a participation loan. Because of the structure of the Act, NCUA would term the transaction as a partial sale of an eligible obligation. Sometimes such transactions are entered into to avoid booking losses on a sale. If a third party that the credit union is participating with is receiving a higher rate of return on its investment than the credit union, the transaction should be carefully reviewed to determine that proper accounting procedures have been followed. Further, when such loans are reviewed, the examiner should review the contract between the investor and the credit union. The contract may require the credit union to assume the majority of the risks in the event of a default. Such a contract would need to be considered when determining the adequacy of the Allowance account.

Following are possible unsafe and unsound operating policies and practices:

(1) Purchase of loans without investigation of borrowers' credit positions, the condition of security properties, and the adequacy of appraisal reports;

(2) Purchase of unacceptable high risk loans to obtain purchase discounts or net yields that are higher than current market averages;

(3) Sales of high-yield loans and replacement of these loans with lower-yield loans;

(4) Sales of loans at a time when there is no current or projected demand for loanable funds; and

(5) Participation sales made only to create income based on yield differential. This is particularly dangerous when the condition described in item (4) above exists.

### 8.5-9 Insured - Guaranteed Loans

The Rules and Regulations permit credit unions qualified as lenders under Federal and state-insured or guaranteed loan programs to make loans to members under the terms and conditions and within the maturities specified by the laws and regulations governing the program. The most common types of loans granted under this authority are loans insured by the Federal Housing Administration (FHA) and loans guaranteed by the Veterans Administration (VA).

Credit unions need to be "FHA approved mortgagors" in order to originate loans under an FHA insurance program. Credit unions would have to have assets of $2,000,000 or more to meet FHA's net worth requirements.

In order to originate VA loans, a credit union would have to qualify as a "supervised lender." Most credit unions qualify.

These programs usually allow a borrower to purchase a home with little or no down payment. While the insurance or a guarantee does not ensure that the credit union will not sustain a loss, it usually provides protection similar to that which the credit union would have if it had required a large down payment from the borrower. FHA/VA loans are more liquid than conventional mortgages since the loans are secured by both real estate and by a government insurance or guarantee contract. Also, FHA/VA loans may be pooled into Government National Mortgage Association (GNMA) pass-through securities.

When insured or guaranteed loans are reviewed, the examiner should ensure that the credit union has developed written procedures to be followed by loan officers and loan processing departments. The credit union also should have current manuals, handbooks, laws and regulations that examiners should become familiar with prior to reviewing insured or guaranteed loans.

### 8.5-10 Balloon Notes

Balloon loans are loans with large final payments. Such loans have inherent risks:

(1) The credit union, due to infrequent contact with the borrower, may not be aware of new financial problems that the borrower may have;

(2) The borrower may be unable to make the balloon payment required (borrower's expectations failed to materialize);

(3) The collateral may become inadequate as a result of depreciation without corresponding amortization of the loan principal; and

(4) The credit union may have liquidity problems due to a lack of cash flow.

Balloon notes were once commonly used to finance real estate with the balloon payment generally ranging from 50 to 60 percent of value. A problem with balloon notes is that at the time the credit union may most need to call the loan, the borrower will be least able to repay or to refinance the loan at another institution.

There has been a resurgence in balloon notes in recent years. This is particularly true for second mortgage loans. Balloon payment loans must be underwritten more carefully and must have lower loan-to-value ratios than loans which provide for full amortization. For example, if a second mortgage with a balloon payment is to secure a loan, the credit union may want to limit the combined amount of the first and second mortgage to 60 percent of the value. Also, a well underwritten balloon loan should document that the borrower has other liquid assets which could be used to liquidate the balloon note if necessary. The application should clearly designate the source of income to make the baloon payment if other liquid assets are not presently available.

Balloon notes present significant problems to management in establishing a sound funds management program. Balloon note assets should be balanced with liabilities that have remote withdrawal prospects.

As a general rule, if an interest payment has not been made on a balloon loan for over 12 months, the credit union should cover the balance of the loan, less the forced sale value of collateral, in the Allowance account. This includes instances where the interest is paid on the balloon loan by increasing the principal balance of the note. Forced sale value is normally considered reasonable market value less 20 percent. Prudent lending policies would dictate that interest should be paid at least quarterly.

The credit committee should consider the risks discussed above prior to granting balloon loans and appropriate procedures, such as updated financial reports, should be instituted. Balloon loans not granted in accordance with sound business practices should be considered loan exceptions.

### 8.5-11 SBA Loans

The Small Business Administration (SBA) was created in 1953 through passage of the Small Business Act. The SBA is an independent agency of the Federal Government.

During the early 1950's, many small businesses which had developed during and after World War II were unable to obtain adequate financing from conventional sources. As a result, the introduction of many goods and services essential to the nation was impaired. Congress established the SBA to help provide financial and management assistance to these firms.

The SBA is empowered to guarantee up to 90 percent of the principal and interest on loans made by credit unions to small businesses meeting prescribed eligibility standards. The portion of these loans guaranteed by SBA may be sold to a new investor, although the originating credit union must retain the non-guaranteed portion and must service the entire loan. The credit union may collect a service fee from a portion of the income earned on the guaranteed portion.

Credit unions may make SBA loans to persons within the field of membership. The loans may be made for plant or equipment expansion, or for working capital. Unless specifically approved by SBA, loans may not be made to refinance debt.

If the borrower defaults and the default continues for 60 days, the investor may require the lender/servicer credit union to repurchase the guaranteed portion of the loan at 100 percent of its remaining principal balance plus accrued interest at the net interest rate. If the lender/servicer credit union elects not to repurchase the loan within 10 days after investor notification, the investor may require the SBA to purchase the loan within 15 days of notification. The SBA will repurchase the guaranteed portion at 100 percent of the remaining principal balance plus accrued interest at the net interest rate. The same repurchase rules hold true if the credit union holds the loan instead of selling it on the secondary market. The non-guaranteed portion of the loan could represent a loss to the credit union in case of borrower default. The lending credit union is forbidden to sell the non-guaranteed portion of the loan and is forbidden to retain the funds, i.e., give the borrower only 90 percent of the loan amount. A further discussion of SBA loans as an investment is in the Investment section of the Guide.

The credit union should have developed written procedures to be followed by loan officers and processing departments. The credit union should also have current regulations and handbooks with which examiners should become familiar prior to reviewing SBA loans.

## 8.5-12 Variable Rate Loans

Both consumer and real estate loans can be made on a variable rate basis.

Variable rate loans are an effective method for a credit union to pass on to the borrower the risk of market increases in interest rates which in turn increase the credit union's cost of funds. Variable rate loans are tied to an index agreed upon by the borrower and the credit union. Movement in the index results in an increase or a decrease in the interest rate which is implemented through changes in the monthly payment, through adjustment of the outstanding loan balance, through extension of the loan maturity, or through a combination of these methods. In the case of long-term real estate loans, a credit union is prohibited from using its own funds as an index, and, if the principal is adjusted the payment of the loan must be adjusted at least every 5 years to an amount sufficient to fully amortize the loan at maturity. If the adjustment in the interest rate is implemented through an extension of the maturity, the adjustment may not cause the maturity to exceed 40 years. Such prohibitions are not present in consumer loans.

From a funds management point of view, a credit union's own cost of funds would be an ideal index. However, the Department of Legal Services has expressed concern about the ability of a credit union to enforce a contract in which the key terms are uncertain or not definable. Thus, the examiner should not recommend that a credit union use its own cost of funds as an index. The following are some of the more common indices:

(1) The average contract interest rate charged by all lenders on mortgage loans for previously occupied homes as published by the Federal Home Loan Bank Board in its Journal.

(2) The average monthly yield on 26-week United States Treasury securities as published in the Federal Reserve Bulletin.

(3) The average monthly yield on the United States Treasury securities adjusted to a constant maturity of 3 years based on daily closing bid prices as published in the Federal Reserve Bulletin.

(4) The average monthly yield on the United States Treasury securities adjusted to a constant maturity of 5 years based on daily closing bid prices as published in the Federal Reserve Bulletin.

(5) The average of "prime lending rates" as published by specific banks.

The underwriting of a variable rate loan is more difficult and more critical than in a fixed rate loan. A variable rate loan to a person on a fixed income could cause the borrower and the credit union serious problems since such an individual may be unable to afford unanticipated increases in the monthly payment. Additionally, when variable rate loans are adjusted through addition of unpaid interest to the principal balance, the result may be that large final payments are required which are potentially risky and dangerous to liquidity, earnings, depreciated collateral and default in the same ways that balloon notes are potentially dangerous in these areas.

The credit union is required to prepare disclosures for variable rate loans in accordance with Regulation Z which essentially requires the lender to disclose the following information in readily understandable language:

(1) Circumstances under which the rate may increase;

(2) Any limitation on the increase;

(3) The effect of an increase. The "effect" refers to an increase in the number or amounts of payments or an increase in the final payment; and

(4) An example of the payment terms that would result from an increase.

The NCUA Board strongly encourages each credit union that offers variable rate consumer loans to establish a member education program for prospective applicants for such loans to help them understand how loans of this type work under varying conditions, including "worst case" situations.

A typical variable rate loan is illustrated in the following example:

> A variable rate loan is granted at an APR of 16%. This rate will increase or decrease in future time periods as the market rate of the index used varies from the established base rate. When the loan is granted, the base rate is established at the current market rate of 13%; the lender has "locked in" a 3 percentage point positive arbitrage. In a future period (quarterly is common, but other periods are also used) the market rate of the index increases to 14%, one percentage point above the base rate, so the borrower's APR would increase to 17%. The lender would retain a 3 percentage point positive arbitrage.

It is possible for a lender to carefully select a base rate to abuse the variable rate concept. For example:

> As in the previous example, a variable rate loan is granted at an APR of 16% when the current market rate of the index used is 13%. However, instead of establishing the base rate at the current market rate, the lender establishes the base rate at some prior period's market rate. If the base rate was set at 10%, the lender would be "locking in" a 6 percentage point positive arbitrage. When the loan is first granted, the "back dated" base is not apparent; the APR is 16% just as in the first example. However, even if no change occurred in the market rate of the index, the borrower's APR would increase to 19% at the end of the first adjustment period because the contract specifies that the APR will be adjusted to remain 6 percentage points above the then current market rate of the index.

A borrower can avoid such unjustified increases (unjustified because the lender's cost of funds did not increase between the time the loan was granted and the end of the adjustment period) only by comparing both the APR and the base rate that various lenders use in their lending contracts.

The examination procedures pertaining to consumer or real estate loans should be followed in reviewing such loans. The purpose of the above discussion is to provide the examiner with some basic background and areas to consider when reviewing variable rate loans.

### 8.5-13 Construction Loans

Construction loans are high risk loans that require sophisticated underwriting and administration. Generally, credit unions do not engage in such loans. To compensate for the risks, commercial banks normally charge 3 to 6 percentage points over the prime rate, commitment fees of one to two points (1 or 2 percent of the total loan amount approved) and require a compensating balance.

Generally, there are four types of construction loans:

(1) Loans to a developer to complete commercial buildings such as a shopping center, office building, hotel, etc;

(2) Loans to a developer to finance residential construction made on a speculative or "spec" basis, i.e., homes built to be sold later in the general market;

(3) Loans to a general contractor to finance single homes to persons who may or may not have obtained prearranged permanent financing; and

(4) Loans to an owner who also acts as the general contractor.

The situation where the owner is acting as the general contractor presents the greatest risk since the person doesn't have a track record. In this situation, the controls upon the borrower would have to be extremely well administered to ensure that construction is taking place as planned and that completion dates will be met. The discussion in this section is generally focused upon loans to developers/borrowers. However, the same basic principles apply regardless of which one of the four basic types of contruction loans the credit union is financing.

The major risks involved in construction lending are:

(1) Failure of the builder to produce the anticipated product;

(2) Threat of prior or intervening liens being placed on the mortgaged property;

(3) Unreliable market analysis resulting in either an unmarketable or difficult-to-market project; and

(4) Inadequate funds to complete construction.

The failure of the borrower to complete a project may be caused by several factors. One could be the diversion of funds to other projects, especially if the releases from the lender are not closely supervised, thereby allowing apparent surpluses to be paid into other projects. This practice could also result in subcontractors being financially unable or perhaps unwilling to work on and complete their portion of the project. Work stoppages, oppressive organized labor practices, material delivery delays and price increases, as well as unanticipated cost increases resulting from governmental agency requirements, all could either greatly delay or cause the failure of a borrower. The borrower is sometimes incompetent to handle either the technical or business aspects of a project.

The credit union should exercise great caution in ensuring that no prior liens existed before the construction commenced or in preventing intervening liens from being placed on the property. Otherwise, the project may be delayed, not completed or require the mortgage lender to advance unanticipated additional funds. Intervening liens could result from a builder diverting funds from subcontractors and suppliers.

Borrowers may fail to fully comprehend the impact of competitive projects on the demand for their development. Overly optimistic sales or rental forecasts, selection of the wrong price or rental range or mistakes in selecting amenities and proper location all may contribute to marketing problems. If a project has been constructed based on earlier successes or past trends, future downturns in the economy or changing consumer tastes could seriously impair the eventual marketing of a project. Thus professional marketability and financial feasibility surveys should be obtained and heeded by the borrower and the credit union.

If the marketing, through sale or leasing, is insufficient to carry the debt service, expensive secondary financing (if permitted) may be necessary over an extended period, which also may adversely affect the profitability of a development. In some instances, loans have been initiated and finalized on a policy of "the blind leading the blind" rather than independent, astute analyses by each of the parties involved. That is, the credit union may be comforted by the builder's former "track record" and rationalize that if the borrower has enjoyed past successes, then the borrower ought to realize success in the present situation. It may well be that past success was achieved in a period of high demand and with a different type of construction.

The feasibility analyst could be guilty of a similar assumption, or an analyst's lengthy report could merely be filed by the credit union without heed to the cautions set forth. The builder, on the other hand, is in business to build and, hence, may not modify the production progress to fit the reduced demand for the product since the lender is willing to make the loan. The end result of interdependence among these three parties may be an unsuccessful project.

Several similar considerations may be common to the analysis and processing of any construction loan application. If an application is accepted, which may be after several requests and modifications of the initial application, the loan commitment is granted. The sequence of steps involved in this lending procedure normally would be as follows:

(1) Application by the borrower;

(2) Appraisal and credit check;

(3) Issue lender's commitment letter (generally conditional);

(4) Examine title to assure that no liens or encumbrances exist which are not revealed in the documents;

(5) Execute documents (e.g., note, mortgage or deed of trust, and construction loan agreement);

(6) Record documents to perfect lender's lien;

(7) Follow loan disbursement schedule (e.g., loan settlement statement, inspections by lenders, receive contractors' statements and waivers to lien and payout orders for work and materials, and disbursement of loan proceeds); and

(8) Repay construction loan from proceeds of permanent financing (i.e., the "take-out" loan).

A key feature in the lending procedure is to require a construction loan agreement. Its purpose is to set forth in detail the rights and obligations of the borrower and lender. This agreement, drawn up by the mortgagor, will specify the staging for disbursements to the developer, the scheduling of inspections, and in some instances any holdbacks. The developer and subcontractors may be required to provide completion and performance bonds. Prior to the loan actually being approved, the credit union should evaluate the financial strength and construction capability of the prospective borrower.

Generally, a credit union would require the borrower to obtain a permanent take-out commitment from a long-term lender as a condition to obtaining a construction loan.

Most construction loans are made to borrowers with take-out commitments. However, contingencies in the take-out commitment, if not met, can cause the permanent lender to retract the commitment. Most take-out commitments require a completion date for construction, the right of the permanent lender to approve all construction change orders, a specific lease rental agreement and other possible conditions before the commitment becomes binding. Unforeseen problems with construction can delay the project beyond the completion date, result in structural design changes unsuitable to the permanent lender or cause the developer not to meet the necessary rental achievement. If any or all of these events should occur, the permanent lender can retract the commitment and the construction lender may have to carry the completed project until a new permanent lender can be found.

A construction loan differs from a permanent real estate loan in that the borrower receives several payments as opposed to one amount. These payments, referred to as drawdowns, payouts, disbursements or advances are most often released as inspections are made by the architect (surveyor or any other inspector on behalf of the lender), who then certifies the amount of work completed and compares budgeted expenses to actual expenditures.

There are two basic forms of disbursements. One is the progress payment plan, wherein the contractor delivers to the construction lender the bills and waivers for work completed for a particular disbursement stage. Once the bills have been checked and the work inspected, the lender, if satisfied, will disburse the requested funds to the borrower and/or the subcontractors and suppliers. In some cases, if the work has not been completed satisfactorily, the full amount will not be disbursed. Another method used is the voucher plan, where the lender will provide the borrower with the necessary forms for requesting payments. As the work is completed for the respective stages, the builder will submit the completed forms along with endorsement by the subcontractors or material suppliers. In some cases, a borrower may request that the construction funds be released on an elapsed-time rather than work-completed basis. Credit unions should avoid this method since it offers no assurance that the work will be completed satisfactorily.

Following are possible unsafe and unsound operating policies and practices:

(1) Disbursement of funds in advance of construction progress. If done, the credit union will not have sufficient undisbursed loan funds to ensure project completion.

(2) Approval of loan agreements that do not include precautionary measures to avoid the filing of mechanics' liens or stop notices. Liens and stop notices can cause costly delays in construction.

(3) Approval of loans for speculative or investment type projects without prior evaluation and approval of feasibility studies, along with sound independent appraisal of land value.

(4) Approval of loans to speculative or investment borrowers without giving due consideration to their past performance record on similar projects and the proposed marketing program for the project to be developed.

(5) Approval of loan agreements that do not provide for progress inspections to ensure that construction has been performed in accordance with approved plans and specifications, and that labor and material for which reimbursement is requested is evidenced by the construction progress prior to disbursement.

(6) Approval of construction loans without prior review of builder's cost estimates to determine their accuracy and reasonableness when related to proposed sales prices or the proposed income stream to be generated by the property.

(7) Disbursement of construction funds that are not properly supported by inspection reports.

(8) Approval of loan agreements that do not provide that changes in plans and specifications can be made only with prior approval of the credit union.

(9) Failure to segregate construction loan appraisal, inspection and disbursement functions.

(10) Granting loans to builders/developers with insufficient equity in the project to ensure sufficient incentives to complete construction and market the project.

Construction loan policies should reveal that:

(1) Objectives for construction lending have been established and are compatible with the credit union's size;

(2) Objectives are related to cash flow projections;

(3) Construction lending policies and procedures have been established and are adequate to prevent unsafe and unsound practices; and

(4) Policies and procedures require that construction loans be approved in accordance with the credit union's standard underwriting procedures, including the review and approval of feasibility studies, cost estimates, and the financial stability, cash flow and reputation of borrowers.

At a very minimum, the credit union should have evidence of a financial evaluation of the developer, proper recorded documents, inspections prior to permitting draws by the borrower and a take-out commitment by a permanent lender. If the credit union does not have a take-out commitment from a permanent lender the conclusion to be reached is that the credit union will be the permanent lender. The examiner should consider the effects of such a loan on the credit union's liquidity and profitability and how the credit union intends to structure the permanent loan within the Act and Rules and Regulations.

### 8.6 Allowance for Loan Losses

Transactions occurring in this account during the examination period should be analyzed.

The primary objectives in analyzing this account are to determine:

(1) That proper accounting procedures are being employed;

(2) That the officials and management understand the function and purpose of the account; and

(3) That the account balance accurately reflects full and fair disclosure of probable loan losses.

The examiner should determine compliance with the applicable sections of the Accounting Manual and the Rules and Regulations concerning the Allowance for Loan Losses. Technically, the account represents a segregation of the Regular Reserve. The balance should be added to the Regular Reserve when computing ratios involving irrevocable reserves; and should be considered part of the Regular Reserve for determining the percent of gross income to be transferred to the Regular Reserve at the close of the accounting period.

The Allowance for Loan Losses should represent a reasonable estimate of loan portfolio losses. Functionally this account serves as a valuation allowance and causes loans to be reflected at fair value.

The adequacy of the Allowance for Loan Losses will be determined during each examination. The following general guidelines should be used to test the adequacy of the Allowance for Loan Losses:

If the 50/75 classification was used in lieu of individually classifying loans, then the Allowance for Loan Losses should have a balance of 50 percent of the loans 6 to 12 months delinquent and 75 percent of the loans over 12 months delinquent. If the individual classification procedure was used, the Allowance for Loan Losses should have a balance equal to the uncollectible portion of loans determined to be collection problems.

If collection problem loans are materially different from the Allowance for Loan Losses, the officials should increase (or decrease) the Allowance to an amount necessary to accurately reflect the value of the loan portfolio. In order to meet the requirements for full and fair disclosure, necessary increases to the Allowance should be made prior to payment of any dividend. Illegal dividends could result from piecemeal increases to an already inadequate Allowance. Examiners should resist any effort on the part of officials to establish or continue a piecemeal approach to maintenance of an adequate allowance account.

### 8.6-1 Simplified Classification

Statistical studies of credit union loan losses have shown that the probability of a loan becoming a loss increases with the length of delinquency, i.e., the value of a loan decreases proportionately to the number of months a loan is delinquent. Based on these statistical studies a reasonable estimation can be made that 50 percent of the loans between 6 and 12 months delinquent and 75 percent of the loans over 12 months delinquent will become losses. By comparing the amount in the Allowance for Loan Losses to the total of 50 percent of the loans between 6 and 12 months delinquent and 75 percent of the loans over 12 months delinquent, the examiner should be able to estimate the adequacy of the Allowance for Loan Losses. If the amount in the Allowance is materially equal to the 50/75 classification, the examiner will not need to individually classify delinquent loans.

If the amount in the Allowance is materially overstated or understated in relation to the 50/75 classification, the examiner should consider the following:

(1) Would the application of the 50/75 classification of delinquent loans impair the dividend paying ability of the credit union?

If the 50/75 classification will lead to an unanticipated change in dividend policy, the individual classification procedure should be used. If the 50/75 classification does not impair the dividend:

(2) Would the application of the 50/75 classification of delinquent loans lead to a material overstatement or understatement of the Allowance for Loan Losses?

Individual credit unions may have situations which are unique to their operations. A low loss ratio, a strike or layoff are some of the factors that may be considered when making the determination that the Allowance account is adequate. If the Allowance for Loan Losses would be materially mis-stated by using the 50/75 classification of delinquent loans, the individual classification procedure should be used. The 50/75 classification will not be used in those cases where there are material differences and the officials do not agree that the 50/75 method accurately reflects the Allowance or where NCUA may consider an administrative action against the credit union.

### 8.6-2 Individual Classification

In those cases where the 50/75 classification of delinquent loans is not appropriate, individual classification will be used. As a minimum, the individual classification will be used when loan delinquency:

(1) exceeds irrevocable reserves,
(2) has increased significantly, or
(3) is inverted.

The examiner should analyze the delinquent loans to determine the amount of collection problem loans and to further classify them as doubtful of full collection "CP-D" or as losses "CP-L." The examiner must recognize that the classification of these loans and the manner in which they are handled are key points in the supervision of the credit union being examined. In arriving at the decision about the proper classification, information should be solicited about each loan from the credit union's employees and/or officials.

The examiner should be guided by the following considerations when making individual classifications:

(1) Any loan that is delinquent 6 months or more should be a classified loan, unless the last payment (excluding transfers from shares or proceeds from sale of collateral) has been made within 2 months of the effective date of the examination and the last payment is equal to at least 75 percent of the monthly payment as shown on the note. If a payment is received after the effective date of the examination, this fact should also be considered in determining the classification.

(2) All delinquent loans in the hands of an attorney or collection agency or where the borrower is adjudged bankrupt or is a "skip" should be classified, unless there are extenuating circumstances which lead the examiner to believe that the loans will be collected.

(3) Any loan on which a substantial portion of the principal (if collected) would be absorbed as collection costs, should be classified.

(4) Any loan on which the examiner feels that a substantial portion will not be collected, even though there are small regular or irregular payments, should be classified.

(5) Seriously delinquent loans with comakers as security on which adequate information is lacking should be classified. Loans secured by collateral with questionable value on which payments are irregular and falling behind, and there is no reliable information on file on which to realistically evaluate the collateral, should also be classified.

(6) Any other loan should be classified if warranted. Examples are:

a. Loans which are not delinquent, or are not seriously delinquent, only because of unwarranted extension agreements, refinancing, or application of the proceeds of the sale of repossessed collateral.

b. Loans which are in a current status but which may represent potential losses to the credit union because of questionable security.

c. Loans which are in a current status according to their terms but which may represent potential losses because of the payment terms or because of past practices of observance, or lack of observance of these terms. Included in this category might be single payment loans and "balloon" loans which have been repeatedly refinanced or extended to the extent that the amount of credit granted is inconsistent with the borrower's record of making payments on the loans.

d. Loans which may be considered as risks to the credit union because of their nature. This might include loans secured by real property or loans granted for "business" purposes even if such loans do not fall into category c., above. This risk to the credit union might stem from a number of areas, possibly involving the credit union's inability to properly maintain continuing appraisal of the loan collateral or its inability to dispose of the collateral if necessary.

If a loan to be classified is less than 2 months delinquent, it should be listed on NCUA 2110, Classified Loans. The examiner's reasons for classifying the loan should be stated in the "Comments" section of the workpaper.

Determining whether a collection problem loan should be classified as doubtful of collection or as a loss will require the examiner to apply analytical skills. In the interest of uniformity, the following will serve as a general guideline to distinguish between a doubtful loan and a loss loan.

A collection problem loan should be classified as doubtful when a substantial degree of credit risk is present, and collection in full, based upon existing facts, is highly improbable. A loan classified as doubtful of collection contains a high degree of loss probability, but because of certain important factors not yet determinable, its classification as a loss is deferred until such time as a more exact appraisal can be made. Under ordinary circumstances, the unknown factors which caused the loan to be classified as doubtful will become known within a short period of time and the doubtful classification will no longer be appropriate. Only in rare instances should it be necessary to continue classifying a loan as doubtful over prolonged periods of time.

A collection problem loan should be classified as a loss when it is uncollectable and worthless as a credit union asset. Such loans should be charged off to the Allowance for Loan Losses. Frequently loans which are classified as losses and charged off are partially recovered. This does not mean the examiner's classification of the loan was in error or too severe. It simply means the credit union recognized the basic fact that it is not practical or desirable to defer charging off a worthless asset because a small or partial recovery may be affected at some future date. The examiner should not await the wringing out of the final collectible dollar from a loan prior to classifying it as a loss for charge off.

The examiner should determine the estimated uncollectable portion of each loan classified as doubtful based on the considerations used to classify the loan as a collection problem. Normally a loan classified as a loss will be considered as totally uncollectable unless noted otherwise. The comments section of NCUA 2110 should be used to reflect any known collateral values including shares. Comments should also be provided on NCUA 2110 or other workpaper to document how the estimated uncollectable amount was arrived at.

### 8.6-3 Collection Problem Loans, NCUA 2110

In order to satisfactorily appraise delinquent loans and collection policies and practices, the examiner must have a reasonably accurate list of delinquent loans. Once this basic information has been obtained, the examiner should be able to evaluate management in this key area of operations and to assist the officials if collection problems exist or trends indicate potential difficulties.

If the credit union's delinquent loan schedule is current and reasonably complete and accurate, it can be used by the examiner as a basis for preparing NCUA 2110, Collection Problem Loans. When the examination is started early in the month and a delinquent loan list has not been prepared as of the effective date of the examination, the prior month's delinquent loan list may be used with that date reflected on NCUA 2110. The ratio of delinquent loans to total loans will be computed on the total loans outstanding as of the effective date of the examination. A copy of the credit union's schedule of delinquent loans need not be submitted with the workpapers unless it will serve a definite purpose.

If there is no current delinquent loan schedule, or if it is not materially complete and accurate, the examiner should request credit union staff to prepare one. In cases where the preparation of the list will require a substantial amount of time, the examiner may defer the completion of the examination. The examiner should determine why the schedule has not been prepared and should establish appropriate plans with officials to correct the problem.

A sufficient number of loans should be tested to determine the accuracy of the credit union's delinquent loan schedule by using the delinquency computation methods explained in the Accounting Manual. This can be done in conjunction with other areas of the loan review. The extent of the test will be recorded on NCUA 2055, Examination Scope. When one or more loans are determined to be improperly categorized or omitted from the credit union's delinquent loan schedule, an examiner-designed workpaper should be prepared to reflect the correct categorization for all such loans. Also, a reconciliation of the Summary of Delinquent Loans should be included on this workpaper to reflect the credit union's summary, the corrections made by the examiner and the corrected Summary of Delinquent Loans. The corrected summary should be shown on NCUA 2110, Collection Problem Loans.

To facilitate use of the calculator for delinquency computations, the following example is provided:

Key strokes to determine the number of payments missed for:

(1) A loan of $2,000 with 18 monthly payments of $121.96.

(2) The interest rate is 1% a month and the APR is 12%.

(3) The date of first payment was 6-30-x2.

(4) The unpaid balance was $1,586.04 on 3-31-x3.

| | Enter | Press | Results |
|---|---|---|---|
| Unpaid loan balance | 1586.04 | (PV) | 1586.04 |
| Amount of scheduled loan pmt. | 121.96 | (PMT) | 121.96 |
| *Annual percentage rate | 12 | (÷) | 12 |
| **Number of periods in year | 12 | (=) | 1 |
| Interest rate per unit period | | (%i) | 1 |
| | | (2nd) | 1 |
| | | (N) | 14.001027 |
| | | (-) | 14.001027 |
| Number of payments remaining | 8 | (-) | 6.0010265 |
| Constant | 1 | (=) | 5.0010265 |

Therefore, the loan is 5 months delinquent.

*Any annual percentage rate can be used.

**The above example will produce the number of months delinquent. If the loan is for a period other than monthly:

| | | |
|---|---|---|
| 24 | for | semi-monthly |
| 26 | for | bi-weekly |
| 52 | for | weekly |

Examiners should exercise caution when testing the accuracy of the credit union's delinquent loan list. The examiner should determine which method the credit union uses to calculate delinquency (i.e. Method A, Method B, Alternate Method B, or Method C). One method may not necessarily yield the same result as another. The calculation described above is comparable to Alternate Method B. Use of this method can produce a different result than Method B. For relatively short-term loans, the difference is not significant, but as the original loan maturity increases, the difference becomes more pronounced. If the calculator is used and reflects a disparity in the credit union's classification, the examiner should determine whether the disparity is due to the use of a different method, before reclassifying the delinquency of loans. A disparity could also arise if the credit union has added single interest insurance to the loan balance to protect their security interest, or if the credit union adds a monthly CDI charge to the loan balance.

### 8.6-4 Collection Procedures

An important criteria in the appraisal of collection procedures are the delinquent loan and loss ratios. These ratios show the past loss experience of the credit union and its current potential loss position.

Even if the ratios are low, however, the credit union should be prepared for an intensive collection program. A strike, layoff, plant closing or budget reduction can change, in a very short period, what appears to be an excellent collection program into a disorganized, ineffectual effort. The first indicator of problems of this type will usually appear as a rapid increase in the number of loans with one or two missed payments, an item that might not always be recognized because these loans would not show up on a delinquent loan list.

Each credit union should develop a unique collection program that will be effective in that credit union, for that field of membership, in that area, etc. Although unique, each collection program usually will share the following common characteristics:

(1) Prompt action. The easiest time to collect on a delinquent loan is before borrowers think they are "forgotten" by the credit union. The first contact should be made within a few days of the first missed payment, long before the loan appears on the delinquent loan list.

(2) Repeated action. A collection effort should consist of a series of payment requests, usually beginning with a gentle reminder and ending with a firm demand for payment.

(3) Varied action. A series of three collection letters, each progressively firmer in tone, often will generate a positive response, but a collection program that includes letters and personal phone calls can be more effective.

(4) Follow through. A final collection letter often threatens legal action if a payment is not received within 10 days. If the threatened action is not carried through, delinquent borrowers may become convinced that they can ignore the credit union with impunity. Follow through also is necessary when a borrower promises to pay. If the payment is not made, an immediate contact should be made.

(5) Proper paperwork. Although usually not considered part of a collection program, properly completed paperwork is necessary to reduce the likelihood of legal actions against the credit union and to take possession of pledged collateral.

Deficiencies in the collection program, policies and/or practices should be discussed with the appropriate officials with agreements reached for corrective action. The collection program is an important part of the credit union's operation and, therefore, deficiencies must be handled in a firm, positive manner. When the examiner believes the collection procedures are weak, NCUA 2310, Collection Program, can be completed and discussed with the officials for their guidance.

Previously charged-off loans should also be reviewed to determine that they have not been "forgotten." Normally, they should be assigned to outside collectors with the requirement that periodic status reports be furnished. A review of those reports may indicate that follow up is not being maintained and that the officials should take appropriate action. That action will often be a search for a different outside collector. NCUA 2055, Examination Scope, should indicate that the area of charged-off loans was reviewed.

If the credit union has an "inverted" delinquency condition (more loans in the 6 to 12 months and 12 months and over classifications than in the 2 to 6 months classification), it may represent a serious problem in the board's management of the collection program and in its timely recognition of loss loans. The examiner should review the reasons for this condition and if necessary, reach agreements with the board to improve the collection program. The examiner should also determine that the board is charging off loans on a current and realistic basis.

Conversely, if the credit union has a "normal" delinquency condition (more loans in the 2 to 6 months classification than in the 6 to 12 months and 12 months and over classifications), it could mean that collection activity is concentrated on the more seriously delinquent loans, or it could represent a developing problem. When this condition is encountered, the examiner should check the loans 1 to 2 months past due to determine if there has been a breakdown in the collection program that is beginning to surface.

When delinquency is serious, the examiner should consider it an area of concern and help the officials develop plans of action to correct and prevent delinquency. To the extent possible, the plans of action should tie into the Supplementary Facts section when it is used to present characteristics and findings from the profile of delinquent and loss loans. The examiner's review of the credit union's collection program should be indicated on NCUA 2055, Examination Scope.

### 8.6-5 Charge-Off of Collection Problem Loans

The examiner should encourage the board of directors to establish a policy for the regular charge-off of uncollectable loans to clear the books of worthless assets.

It will be the examiner's objective to have all collection problem loans that are determined to be losses charged off by the conclusion of the examination. Accordingly, he/she will request the board at the joint conference to authorize the charge-off of those loans that have been judged as "losses." In some credit unions where the board has a reasonable and consistent basis for authorizing the charge-off of loans (such as monthly, quarterly, or at the end of accounting period if less than annually), the examiner may accept the assurance of the directors that they will authorize the charge-off of loans currently considered as losses at least by the next regular date. Such practices should be sound and the agreement with the examiner must be firm. In general, the past performance of the board will guide the examiner to a great extent as to whether he/she will rely on the agreement or insist that the charge-offs be authorized at the joint conference.

When the officials are not charging off uncollectable loans to avoid a higher reserve transfer requirement, the examiner should refer to the Special Reserve for Losses section of the NCUA Rules and Regulations and when necessary make this recommendation to the Regional Director.

Where there are material amounts of loans which the board has avoided charging off and which they will not agree to authorize for charge-off during the examination, the problem should be treated as a major area of concern and the officials asked to provide a written explanation to the Regional Director.

When the board authorizes the charge-off of a classified loan during the examination, an asterisk (*) should be placed next to the listing of the net balance on NCUA 2110, Collection Problem Loans, or on the credit union's delinquent loan list if that is serving as the list of classified loans. The footnote to the asterisk should be completed.

### 8.7 Collateral in Process of Liquidation

When a credit union has loan collateral in its possession which is in the process of being sold, the loan balances may not be fully collectable and the uncollectable portions may be quite large, especially if weak lending practices prevail. The examiner may analyze such loans on an examiner-designed workpaper.

Collateral in the process of liquidation is often liquid, and sometimes subject to misuse. The supervisory committee, in carrying out its auditing functions, should review these activities closely. Potential loss should be determined and included in an individual collection problem analysis or factored into a simplified classification.

### 8.8 Purchased Loans

When analyzing these loans, the examiner should determine that the:

(1) Loans purchased did not result in the total unpaid balances of such loans exceeding the limits established in Section 701.23 of the Rules and Regulations. Student loans purchased in accordance with Section 701.23(b)(1)(iii) and real estate loans purchased in accordance with Section 701.23(b)(1)(iv) are exempted from the five (5) percent limitation;

(2) Accounting procedures for the purchase and collection of the loans conform with the instructions in the Accounting Manual;

(3) Collection practices and procedures as carried out are adequate;

(4) Notes and collateral documents were properly endorsed and are on hand; and

(5) Sound value of loans is recognized in the Allowance for Loan Losses.

When a credit union has a material balance in General Ledger Account 712, Loans Purchased From Liquidating Credit Unions, the examiner should prepare Collection Problem Loans, NCUA 2110, to list any classified loans. The amount of discount set up in the Deferred Income - Discount on Loans Purchased from Liquidating Credit Unions account applicable to the classified loans should be deducted from the totals of the classified loans to determine the net amount of collection problem loans. The totals of the classified loans should then be deducted from the balance in Account 712 to determine the estimated sound value.

When the examiner prepares NCUA 2110 as discussed above, comments should be added to the form somewhat as follows:

> Loans Purchased From Liquidating Credit Unions includes ____loans, totaling $_____, that are classified.

Exceptions taken because of missing documents, etc., should be handled in the same manner as other types of loan exceptions.

When the credit union participates with one or more other credit unions in purchasing the notes of a liquidating credit union, Account 712 will be evaluated at book value, minus the discount, unless the examiner has evidence that a lesser value should be placed on the account.

### 8.8-1 NCUA Guaranteed Loans

Some credit unions have purchased loans from liquidating credit unions under the terms of a contract with the NCUA Board. These contracts provide that the NCUA Board will repurchase a specified amount of these loans within a specified period if the credit union is unable to recover from the borrowers. The examiner should review the terms of the contract to determine that the credit union is in compliance with the contract. Special attention should be given to the accountability of the payments received on the loans since these contract provisions are not always standard. If the credit union has not established a separate account for these loans, as provided in the contract, an adjustment should be made.

During the analysis of these loans, the examiner should consider loan collectability on the same basis as for other loans to members. The amount of collection problem loans should be determined by subtracting the guaranteed portion or dollars from the collection problem loan and using the net amount on NCUA Form 2110, Collection Problem Loans. Any recommendations for changes in the policies and procedures should be made if needed to improve collections.

### 8.9 Loan Exceptions, NCUA 2120

NCUA 2120, Loan Exceptions, will be used to record the following types of exceptions: loan processing, documentation, violations of the Act and/or Rules and Regulations and sound credit extension. If there are numerous similar exceptions, only a representative sample needs to be listed with comments to indicate that not all exceptions were identified.

In addition, when the loan analysis discloses that notes are missing from the files, the examiner should provide the supervisory committee with a list of missing notes, as originally disclosed by the loan analysis, and obtain an agreement that the committee will promptly contact the borrowers to confirm the authenticity of the loans, their balances and the security involved.

When the examiner has found chronic loan documentation and loan quality problems (i.e., the lack of establishing the creditworthiness of borrowers, recording titles, liens, UCC filings, obtaining real estate appraisals, verifying income, etc.) it should be treated as a major area of concern. Where possible, these types of loan documentation problems should be related to loan loss trends at the credit union. This can be further documented by finding similar problems with previously charged off loans and delinquent loans.

Poor documentation is not only indicative of unsound lending practices, but in a liquidation or merger, can significantly reduce the value of the loan portfolio. The examiner should distinguish between occasional omission type loan exceptions versus chronic documentation and lending practice problems when analyzing loans.

During the next contact, if the examiner finds a chronic loan documentation problem of this nature has not been corrected, consideration should be given to recommending administrative action. Surety should be notified of a potential bond claim and request written assurance of continued bond coverage under applicable sections of the bond. The extent of this action will depend on the trends and types of chronic documentation problems found. The examiner should consult with the Supervisory Examiner before making any recommendations.

### 8.9-1 Illegal Loans

Loans made in violation of the Act and/or Rules and Regulations may be listed on NCUA 2120, Loan Exceptions. Instructions regarding the responsibilities of the officials in connection with the violations should be given and appropriate recommendations made. When only a portion of the loans have been reviewed, the officials should be instructed to review all similar loans for legality.

While the surety bond section of the Guide provides more details about surety notification and filing claims where illegal disbursements are involved, the following guidelines are applicable:

(1) If the disbursement was either intentional or material:

a. It will be included on NCUA 2120 and treated as an area of concern in the examination report.

b. The surety company will be notified and requested to provide assurance that bond coverage will not be affected (the examiner should determine that notification is given during the examination and include a copy of the letter with the examination report).

c. An illegal loan disbursement will be called. However, if a credit union has made an illegal loan to a "good faith" borrower, the borrower cannot be compelled legally to return the money in terms other than those found in the original loan agreement. A credit union is compelled to honor the terms of an illegal loan if a "good faith" borrower does not want to renegotiate the loan.

d. A claim will be filed for the balance of the illegal disbursement within the filing period stipulated in the bond if the loan is not renegotiated or corrected within that period. The filing of a claim may be delayed if an extension of time to file a claim is granted in writing by the surety company. In those cases where it is obvious that the officials will not file a claim, specific instructions regarding the need to keep open the right to file should be given with appropriate agreements reached.

(2) If the disbursement was neither intentional nor material:

a. It need not be included on NCUA 2120.

b. It need not be included in the formal examination report.

c. The board should resolve the question of dishonesty and record its decision in the minutes of the meeting.

d. The surety company need not be notified if the directors so decide and record their decision in the meeting minutes. In such case, the examiner should inform them of the meaning of their decision as related to later losses. Under no cicumstances will the examiner make such a decision for the officials.

e. The officials should attempt to renegotiate or correct the loan.

Determining the intent of the violation is the responsibility of the board; its opinion should be stated in the minutes of the joint conference. If the examiner is virtually certain that the violation was intentional even though the board will not go on record to that effect, it should be treated as an intentional violation.

If the examiner finds that similar violations have occurred during two or more consecutive examinations, they should be treated as intentionally granted disbursements. The officials' failure to fulfill their agreement should be frankly discussed, and agreements should again be obtained to have the practices discontinued.

The supervisory committee usually will be responsible for following up to determine that appropriate action has been taken to eliminate illegal loans, and/or to file a claim or keep open the right to file a claim with the surety company. The examiner should make certain that the committee members, as well as directors and appropriate employees, are familiar with their exact duties as related to these loans.

## 8.10 Bankruptcy

On October 8, 1984, significant revisions were made to the United States Bankruptcy Code through the Bankruptcy Amendments and Federal Judgeship Act of 1984. The Act restructures the bankruptcy court system and makes substantial consumer bankruptcy reforms. The intent of Congress in amending the Bankruptcy Code was to correct the problems and abuses that had occurred since the last changes, which took effect in 1979.

Bankruptcies affecting credit unions are:

(1) Chapter 7. This is a liquidation bankruptcy. The individual filing for bankruptcy, referred to as a debtor, is freed from paying his/her debts, particularly unsecured debts. Secured creditors are protected to the value of their collateral, although there are various choices the debtor can make concerning the collateral which are discussed later. The trustee attempts to collect any non-exempt assets for resale in order to pay a dividend to the unsecured creditors. However, in reality, a dividend is seldom available for unsecured creditors. In about 97% of all Chapter 7 consumer bankruptcies, unsecured creditors receive nothing. Such cases are known as "no-asset" cases and occur when all of the debtor's assets are either exempt or subject to a security interest.

(2) Chapter 13. The debtor proposes a plan which must be approved by the bankruptcy court to pay part or all of his/her debts, usually over a three year period unless a five year plan is approved.

The critical distinctions between Chapter 7 and Chapter 13 bankruptcies are what the debtor keeps and what he provides to the creditors. Under a Chapter 7, the debtor keeps his future income, and gives up his unprotected assets for his creditors. Under a Chapter 13, the debtor keeps all of his assets, but provides for the creditors a portion of his future income.

8.7-1 Chapter 7 Overview - A Chapter 7 process from beginning to end normally takes a minimum of four to six months. The stages of a Chapter 7 bankruptcy are as follows:

1. Petition. The process commences with the filing of a petition in Federal court and the payment of $60.

2. Bankruptcy Alternative Awareness. The new law requires the bankruptcy clerk to give the debtor a written notice explaining the differences between Chapter 7 and Chapter 13 bankruptcy prior to the petition being filed. Further, the debtor has to submit a sworn statement that he has been made aware of the Chapter 7 and Chapter 13 alternatives, understands the relief available under each chapter, and chooses to proceed under Chapter 7. If the debtor is represented by an attorney, which is in most cases, the attorney must now file an affidavit with the court stating he has explained the differences.

3. Schedules of Financial Position. The debtor must file a detailed schedule of his debts, creditors, income, and expenses, with the petition. The new law requires that income and expenses be incorporated into the schedule so that a complete picture of the financial condition of the debtor can be obtained. The procedure to obtain a copy of the schedules is outlined on the bankruptcy notice. The credit union should request a copy of the schedules prior to attending the meeting with the creditors to determine what value the debtor places on the collateral, what property he claims as exempt, and the financial situation of the debtor in general.

4. Substantial Abuse. The new Bankruptcy Code now allows bankruptcy judges to dismiss a Chapter 7 petition if it represents a substantial abuse of the bankruptcy system. In the past, many debtors filing Chapter 7 had a source of income which could have repaid a portion of their debts in Chapter 13. The addition of income to the schedules filed with the petition will be a key factor in identifying substantial abuses. A substantial abuse hearing, however, is determined and initiated by the court, not the creditors.

5. Appointment of Trustee. A trustee is appointed to handle each petition. The trustee questions the debtor at the first meeting of the creditors to determine which assets can be collected by the trustee and sold for the benefit of unsecured creditors. The trustee reviews the liens of the secured creditors to make sure they have been perfected, for instance, by being shown as lienholder on the vehicle title or a UCC filing. This is very important since a secured creditor who did not perfect his security interest would be considered unsecured.

6. Bankruptcy Notice. The bankruptcy notice indicates an Order for Relief has been entered in favor of the debtor. This means the automatic stay is in effect and the credit union is prohibited from taking any action to collect from the debtor or from doing anything with the collateral. An expanded discussion on the Automatic Stay is provided later in the subsection. A notice is sent to all creditors included in the schedules mentioned earlier.

7. Proof of Claim. A proof of claim is a statement of the credit union's right to payment. It is recommended that the credit union file the claim before the first meeting of the creditors although it is permissible to file it within 90 days of the meeting. If the bankruptcy is a "no-asset" case, the bankruptcy notice will state whether the holder of an unsecured claim should file a proof of claim.

   The credit union must attach a copy of the promissory note to the proof of claim. If a secured creditor, the credit union will also attach proof of perfection of security interest as well, i.e., UCC-1 or lienholder on a certificate of title. A cosigned note with no other collateral is unsecured. The credit union's loan balance in excess of the value of the collateral will be considered as a partially unsecured claim. The initial value of any collateral is included in the debtor's schedule. If there are no objections from the creditors, the value determined by the debtor will be accepted. The credit union's attorney must file a formal objection if there is disagreement concerning the value of the collateral. The court would then schedule a hearing and determine the value after hearing evidence from the debtor and creditor.

8. Collateral Disposition Statement. The new code requires the debtor within 30 days after filing a Chapter 7 petition, but no later than the first meeting of the creditors, to file a statement of his intention to retain or surrender collateral securing loans. The statement must specify whether the debtor claims the property as exempt and whether he intends to redeem the property or reaffirm the debt. Within 45 days after the meeting of the creditors, the debtor must perform his intention and the trustee is obligated to ensure that he does.

9. Meeting of Creditors. The meeting of creditors is held within 20 to 40 days from the filing of the petition. The judge is not present at the meeting of creditors since it is conducted by a bankruptcy clerk and is tape recorded. The trustee questions the debtor under oath, followed by the creditors, trying to locate assets which can be collected for the benefit of unsecured creditors. The trustee reviews transactions by the debtor 90 days prior to the bankruptcy filing for preferential payments which can be collected by the trustee. Under the old code any payments to unsecured creditors in this 90-day period would be a preference since unsecured creditors cannot receive, during this period, any more than the creditor would be entitled to under Chapter 7 bankruptcy.

The new Code specifies that payments not exceeding $600 within 90 days preceding the bankruptcy filing will no longer be a preference the trustee can recover. If $601 or more is received it is a preference and can be recouped by the trustee. The $601 or more applies to all unsecured loans the debtor has with the credit union. The credit union does not have to be represented by an attorney at the meeting of creditors although it is definitely recommended in the case of a secured claim. In fact, a credit union with an unsecured loan may not want to attend the meeting in a no-asset case unless there is a chance of obtaining a reaffirmation or voluntary payments. However, a credit union which has secured claim would question the debtor about the location of the collateral and whether it is insured. The credit union or its attorney would discuss the debtor's statement of intention filed with the court (Collateral Disposition Statement). A fully secured creditor's lien is protected in bankruptcy. The debtor may redeem by paying the value of the collateral, reaffirm or reinstate the debt and continue to make payments, or turn the collateral over to the credit union if the trustee agrees to this. Both the secured and unsecured creditors should ask the debtor if he was counseled by his attorney on the difference between Chapter 7 and 13 bankruptcy.

Following the meeting of creditors, the trustee collects non-exempt assets and sells them to obtain a dividend for the unsecured creditors.

10. Discharge Hearing. When a loan is discharged, the debtor becomes free of the discharged debt. Discharge is the court's authorizations to the breaking of a contract between consenting adults. A secured creditor can still proceed to enforce its lien even after discharge. Discharge lifts the automatic stay. A debtor can have his debt discharged under Chapter 7 not more frequently than once every six years. The discharge hearing is generally held about four months after the meeting of creditors. The bankruptcy notice provides a date for filing an objection to discharge which would then be considered at this hearing. At the meeting, the judge reviews any challenges to discharge, acts on reaffirmations of debts not represented by attorneys, and discharges the debts. Certain debts are not dischargeable in bankruptcy. Among the debts that can be rendered undischargeable are those relating to certain unpaid taxes, certain sums due to a child of the debtor or former spouse for maintenance or child support and certain educational loans. Also, certain debts arising from embezzlement and certain debts that

were not listed in the bankruptcy schedule in a timely manner, preventing the creditor from filing a timely proof of claim can be expected. A debt can also be rendered nondischargeable if a secured creditor can prove that the debtor wilfully and maliciously injured its collateral or if the debtor fraudulently obtained money or property or an extension or renewal of credit.

The new code presumes that debts of more than $500 for luxury goods or services incurred within 40 days before filing cannot be discharged in bankruptcy. Cash advances of more than $1,000 that are extensions of consumer credit under an open-end credit plan obtained within 20 days before filing the petition are presumed to be nondischargeable. Both items refer to each individual creditor. Luxury goods are those not acquired for the support or maintenance of the debtor or his dependents. Creditors may now request a determination of dischargeaibility of a consumer debt without becoming liable for the debtor's costs and attorneys fees unless special circumstances make the award of such costs and fees "just." The credit union will receive a discharge notice following this hearing indicating that the member's debt is eliminated. At this time, the credit union should charge the loan off the books, first setting off any shares frozen from the time the petition was filed.

## AUTOMATIC STAY

Immediately upon the filing of the petition, the bankruptcy stay automatically takes effect. The stay works like an injunction, prohibiting the creditor from trying to enforce a debt. If a credit union repossessed a car, and then received a bankruptcy notice, the car cannot be sold without asking the court to lift the automatic stay. A creditor not listed on the statement is affected by the automatic stay to the same extent as if listed if aware of the filing. The credit union is not subject to the stay unless and until they are aware of the bankruptcy filing.

1. Automatic Stay and Co-debtor. In a Chapter 7, the automatic stay does not apply to a co-debtor. A co-debtor is any other person liable on the debt including a cosigner. The credit union should initiate collection efforts without delay.

2. Automatic Stay and the Right of Set Off. The credit union can freeze the shares available at the time of the filing and apply them to the loan balance when the automatic stay is lifted at discharge. If the amount in shares is significant, the credit union can seek relief from the automatic stay by filing with the court and if relief is granted, apply the funds to the loan immediately. It is essential that the credit union determine as soon as possible the date of the filing of the petition. The date is important, not only because it initiates the automatic stay, but also it is the date which determines pre-petition deposits and post-petition deposits. All post-petition (after filing) are the property of the member.

3. Automatic Stay and Payroll Deduction. Continuing to receive funds that go into the member's share or share draft account, whether personally or through payroll deduction, does not violate the automatic stay. The payroll deduction itself is not an act to collect the loan, as it is an independent contract between the member and the sponsor. However, the member is entitled to all funds received

by the credit union after the date of filing. If a member notifies the credit union to stop payroll deductions, his request must be honored. If a member wants to continue to pay his loan, have the member sign a reaffirmation and have it counter-signed by his attorney or the court. If the member wishes to continue payroll deduction and have payments applied to the loan without reaffirming, the credit union should consider getting the member to sign a statement instructing the credit union how to allocate the payroll posting. The credit union may also accept voluntary payments from the member at any time. As a precaution, however, the examiner should recommend that the credit union consult their attorney for his direction if the member offers alternative repayment plans.

4. Violation of the Automatic Stay. The new code allows debtors to collect punitive damages, including costs and attorney fees, from those who wilfully violate the automatic stay.

5. Release of Automatic Stay. The automatic stay is automatically lifted when the case is closed or dismissed or a discharge granted or denied. The credit union's attorney can petition the court to have the stay lifted to permit the credit union to take and dispose of the collateral prior to waiting for the discharge. This is done through an agreed order or motion. The stay is automatically terminated 30 days after the court is petitioned unless the debtor or trustee objects to the stay being automatically lifted. If there is an objection, a hearing will be held within 30 days. The credit union's attorney will have to prove that there is no equity in the property, and it is not necessary to the debtor. The court will release the stay without a hearing if there is the danger the debtor may harm or conceal the collateral or not have the insurance coverage.

## EXEMPTIONS

An exemption is property the debtor can keep free of claims of unsecured creditors. The debtor can use his exemptions to keep the trustee from selling certain property so there is not a dividend to give to the unsecured creditors. The debtor when filing his petition declares which property he is claiming as exempt. It is automatically exempted unless a creditor or the trustee objects.

## FEDERAL EXEMPTIONS

The following is a summary of the allowable Federal exemptions. The amounts should be doubled for joint petitions:

(1) Equity up to $7,500 in real property or personal property (such as a mobile home or house) that the debtor or a dependent of the debtor uses as a residence, or in a burial plot for the debtor or dependent of the debtor.

(2) Equity in one motor vehicle up to $1,200 in value.

(3) Up to $200 in value for each item of household furnishings, household goods, wearing apparel, appliances, books, animals, crops or musical instruments that are held primarily for personal, family or household use. This means that the debtor can claim an unlimited number of these items as exempt so long as each particular item is not worth more than $200. If the debtor and a spouse file a joint petition, they can claim each and every item worth up to $400 in value.

(4) Jewelry worth up to $500 in value.

(5) Up to $400 of any other property the debtor wishes to exempt, including cash. This is what is referred to as the "catch all" exemption. The catch all exemption can be used to exempt the nonexemption of other property. For example, a debtor with a $1,500 motor vehicle could use $300 of the catch all exemption to exempt the full $1,500 of the motor vehicle exemption.

(6) A "wildcard" exemption has been added to the new code representing the unused portion of the residence exemption. The catch all can be added to the wild card exemption for unused homestead exemption of $3,750 if the debtor rents, which would enable $4,150 for a single or $8,300 for a joint petition. This can be used in conjunction with other exemptions. The wildcard in the new code was reduced to $3,750 from $7,500.

(7) Up to $750 worth of implements, professional books or tools of the trade.

(8) Any unmatured life insurance contracts and up to $4,000 accrued dividends, interest or loan value under such contracts.

(9) Any unlimited amount of professionally prescribed health aids for the debtor, or a dependent of the debtor.

(10) The debtor's right to receive such benefits as social security benefits, unemployment compensations, local public assistance benefit, veterans benefits, disability, illness or unemployment benefits, alimony and child support, payments under a stock bonus, pension, profit sharing, annuity, or similar plan, certain damages for injuries in accident cases and other types of benefits.

State exemptions may supercede Federal exemptions such as in New York State.

## SUPEREXEMPTIONS

A superexemption is a special exemption allowing a debtor to avoid a lien on certain property by making a request to the court. The superexemptions apply in both Chapter 7 and 13. For example, a car can be considered a tool of the trade if necessary in the debtor's business and, therefore, exempt from the lienholder.

## CHAPTER 13 OVERVIEW

Although Chapter 7 and Chapter 13 bankruptcies are inherently different, many of their stages are similar. The following summarizes the process involved in a Chapter 13 Bankruptcy:

1. Petition. As with Chapter 7, a Chapter 13 bankruptcy commences with the filing of a petition, at which time the automatic stay goes into effect.

2. Chapter 13 Statement. A Chapter 13 statement must be submitted within 15 days of the petition filing. It provides detailed information on income, occupation, budget, and creditors. This statement is usually filed at the same time as the petition.

3. Plan. The plan must also be filed within 15 days of the petition filing. It may propose to pay all or part of the debts. The debtor determines which creditors will be paid and to what extent. The plan length is usually three years unless the court approves five years.

4. Notice. A Chapter 13 notice entitled "Order for Meeting of Creditors, Combined With Notice Thereof and of Automatic Stay" is sent to all creditors within 20 days of the petition filing. Included with the notice is a summary of the proposed plan, notice of the confirmation hearing, and the last date for filing objections to the plan. The notice includes the procedure for obtaining the financial schedules.

5. Proof of Claim. Both the secured and unsecured creditors must file a proof of claim. The deadline for filing a proof of claim is 90 days after the meeting of the creditors. However, as in the case of Chapter 7, the creditor is strongly encouraged to file the proof prior to the meeting with the creditors.

6. Meeting of the Creditors. The meeting is presided over by a standing trustee since the trustee is not appointed until after the plan is confirmed.

7. Payments. The new code requires the debtor to begin making payments to the trustee within 30 days of filing the plan. The trustee is required to ensure that timely payments are made. The debtor no longer has to wait for court confirmation of the plan prior to making payments.

8. Plan Confirmation. The confirmation hearing is usually held immediately after the meeting of the creditors. The trustee advises the court whether the plan should be confirmed, and the judge makes a determination on whether the plan is accepted. The bankruptcy court may confirm the plan only if it calls for the payment of 100% of the debtor's unsecured debts, or requires the debtor to devote all of his "disposable income" to the plan. The debtor's disposable income is the income that is not necessary for the support and maintenance of himself and his dependents.

9. Appointment of Trustee. The court appoints a bankruptcy trustee who will receive payments from the debtor and distribute them the to creditors.

10. Discharge. Chapter 13 discharge is granted as soon as possible after completion of all plan payments. The discharge covers all debts except the following:

    a. debts not listed in the plan,

    b. alimony, maintenance, and child support payments,

    c. long-term obligations whose last payments are due after the last payment under the plan, and/or

    d. post-petition debts.

    A hardship discharge may be granted after notice and hearing where the debtor cannot complete the plan because of circumstances beyond his/her control.

## CHAPTER 13 CODEBTORS AND THE AUTOMATIC STAY

The automatic stay, which goes into effect with the filing of the petition, applies to the codebtors in Chapter 13. The credit union must request relief from the stay to proceed against the codebtor to the extent not paid under the plan. The judge will lift the stay within twenty days of the request unless there are written objections. The codebtor can be required to pay interest at the contractural rate on the entire claim to the extent interest is not paid by the debtor.

## CHAPTER 13 ELIGIBILITY

An individual with regular income having less than $100,000 in unsecured debts and less than $350,000 in secured debts can file Chapter 13 bankruptcy. Income does not have to be derived from wages. An unemployed spouse may file a joint petition with an employed spouse.

## DISMISSAL

A Chapter 13 plan may be dismissed or converted to a Chapter 7. It will be acted on by the bankruptcy court after notice and hearing. The law provides for dismissal when the debtor delays filing a plan unreasonably, fails to pay a filing fee, delays the proceeding in a way prejudicial to creditors, is denied confirmation of a plan, or defaults materially on a confirmed plan.

## SOURCES/REFERENCES

1. "for your INFO. . .", Bankruptcy, September 1984, New York State League
2. Credit Union Magazine, "Be sure you know Chapters 7 and 13", pgs 46-48, November 1984
3. Virginian, "Handling a member's bankruptcy", page 4, January 1986
4. Examiner's Guide, Section 8.7 - Bankruptcy, September 1984

## 8.11 Workpapers and References

(1) Workpapers

- a. NCUA 2036, Supplementary Facts
- b. NCUA 2055, Examination Checklist
- c. NCUA 2110, Classified Loans
- d. NCUA 2120, Loan Exceptions
- e. NCUA 2255, Loan Policies
- f. NCUA 2270, Loan Profile
- g. NCUA 2280, Large/Real Estate Loan Profile
- h. NCUA 2290, Lines of Credit - Credit Cards
- i NCUA 2296, Commercial Loan Checklist
- j. NCUA 2300, Large Loans/Concentrations
- k. NCUA 2310, Collection Program

(2) References

a. Federal Credit Union Act

1. 107(5) - Authority to Make Loans
2. 107(5)(A)(i-ix) - Terms and Rates
3. 107(5)(B) - Lines of Credit
4. 107(5)(C) - Loans to Credit Unions
5. 107(5)(D) - Loans to Credit Union Organizations
6. 107(5)(E) - Participation Loans
7. 114 - Credit Committee

b. Federal Credit Union Bylaws

1. Article IX - Credit Committee
2. Article XII - Loans to Members and Lines of Credit to Members

c. NCUA Rules and Regulations

1. 701.21-1 - Lending Policies
2. 701.21-1A - Interest Rates on Loans to Members
3. 701.21-2 - Amortization and Payment of Loans to Members
4. 701.21-3 - Lines of Credit to Members
5. 701.21-4 - Loans to Officials
6. 701.21-6 - Long-Term Fixed Rate Mortgage Loans
7. 701.21-6A - Business Relationship with Mortgage Lender
8. 701.21-6B - Adjustable Rate Mortgage Loans
9. 701.21-7 - Loan Participation
10. 701.21-8 - Purchase, Sale, and Pledge of Eligible Obligations
11. 702.3 - Full and Fair Disclosure Required
12. 703.2 - Investment in Loans to Nonmember Credit Unions

d. Accounting Manual for Federal Credit Unions

e. Credit Manual for Federal Credit Unions

## 9. Investment Analysis

In many credit unions, the investment portfolio represents a substantial portion of assets. Likewise, investment income is an important means of meeting reserve requirements, operating expenses, and dividend needs. The ability of management to wisely invest its excess funds has become increasingly important.

Objectives during an investment analysis are to determine:

(1) The adequacy of policies, procedures, and internal controls regarding investments;

(2) The legality of investments, as well as compliance with related regulations, accounting procedures, and other guidelines;

(3) The value of the investment portfolio and to evaluate the effect of realized or potential losses from investment transactions on the earnings and financial condition of the credit union; and

(4) That action is initiated to correct investment-related problems.

The extent of the examiner's review of investments will depend upon the quality of investment policies, practices, and internal controls; the condition of investment records; the volume and materiality of investment transactions; and the degree of problems disclosed by previous audits or examinations. The review should be sufficient to accomplish the objectives stated above. The examiner will record the extent of the investment analysis on NCUA 2055, Examination Scope. The examiner will also complete NCUA 2390, Investment Internal Control Questionnaire.

### 9.1 Policies

The credit union should have an investment policy (in writing and approved by the credit union board) and should monitor compliance with this policy. If the investment review discloses exceptions to sound investment policies, the examiner will recommend changes to, or enforcement of, the current investment policy.

The scope of the credit union's investment policies will depend upon the size of the credit union and its make up of assets. As a minimum, the policies should address the following areas:

(1) Objectives - In establishing its investment objectives, the board of directors should be reminded that the credit union was chartered to serve its members. In formulating objectives, investments become an integral part of the overall goals and objectives of the credit union. Generally, objectives try to balance the need for liquidity against the need for yield. The objectives should be flexible enough to respond to rapid changes in the economic climate.

(2) Legality - Sections 107(7) and (8) of the Act and Part 703 of the Rules and Regulations set forth permissible investments.

(3) Diversification - The board of directors should establish the types of investments and the maturity limits and amounts to be invested in each permissible type.

(4) Liquidity - Investment policies must be flexible to allow for changes in balance sheet items (Share and Loans) and in changes in the economy (movement of interest rates). Each time there is a shift in either of these areas there may need to be a shift in the investment strategy in order for the credit union to meet different demands and still remain liquid.

(5) Risk - Despite being limited by law to investments that are primarily guaranteed as to principal and interest, certain investment risks do exist for credit unions. These risks include:

(a) Market risk - a possible reduction in value resulting from changes in market demand.

(b) Interest rate or maturity risk - a possible reduction in value resulting from increases in interest rates.

(c) Credit risk - a possible loss if the issuer of an investment defaults.

(d) Transaction risk - a possible loss resulting from failure of broker/dealer or from inappropriate safekeeping arrangements for securities. Over the past few years, credit unions have suffered a significant amount of losses resulting from the failure of government securities dealers. It must be understood that the majority of the participants in the government securities market are unregulated. Therefore, the selection of a broker/dealer is an important task undertaken by the credit union. The following steps should be recommended to the officials as a minimum procedure to follow while analyzing and selecting a broker/dealer:

(i) Stick with established, well reserved and reputable national or regional firms. The larger the equity, the greater the chance that the firm will not fail and/or the credit union can have something for which to sue, if necessary.

(ii) Obtain audited financial statements for the last three years from the broker and review them. Look at the capitalization and growth in retained earnings. Good firms return profits to the firm.

(iii) Ask the broker if the firm complies with the Securities and Exchange Commission's Uniform Net Capital Rule or the Federal Reserve Bank of New York's capital adequacy standard. The unregulated firms are asked to voluntarily comply with the Federal Reserve's 1.2-to-1 capital-to-risk standard.

(iv) Don't rely on the strength of the firm. Check the salesperson's knowledge and skills. Obtain a resume. Determine what training the firm provides its salespersons. Most reputable firms have schools.

(v) Check reputations. Ask for three to five references from the salesperson and the firm. Check with other credit unions, chapters and leagues as well as the references. Specifically ask for and obtain a written response confirming or denying if the firm has been sanctioned in the last five years by the Securities and Exchange Commission, the National Association of Securities Dealers, or a state authority. Do the same for each salesperson. Then check with the SEC, the NASD and the applicable state authority.

(vi) Don't deal with salespersons who can't or won't take the time to explain in depth the type of security they want to sell.

(vii) Deal with a least three brokers and get quotes from each. Don't accept last minute substitutes.

Credit unions can reduce investment risks by fully evaluating each type of investment prior to purchase, including the creditworthiness or the financial condition of the issuer; by analyzing the financial condition and reputation of any intermediary to the transaction, such as a broker/dealer; and by diversifying the investment portfolio by type, maturity, geographical location, guarantor, etc.

(6) Marketability - Before making any investment, the credit union must have an understanding of the investment. In the financial world, a credit union's ability or inability to make a quick decision to purchase or to sell an investment could result in a gain or a loss of a material amount. By the same token, a quick decision to invest in a security or to enter into a transaction that management does not understand could result not only in potential losses but also in long-term liquidity problems. Therefore, the credit union's investment policies should completely describe the investments in the program and the pros and cons connected with investing in them.

The officials and the employees should understand the investment transactions entered into by the credit union because the investment market is changing continually. Additionally, the officials should be aware of how future market conditions may affect their current decisions. When necessary, the examiner should recommend that professional advice or assistance be sought. However, officials should not delegate their authority for making investment decisions to outsiders nor rely solely on professional advice.

(7) Accountability - The board of directors' authority for authorizing the investment of credit union funds may be delegated to an executive or investment committee. If this is done, board policy should state explicitly the authority delegated to the committee. In turn, the board, or one of the committee, may authorize an individual, such as the manager or an investment officer, to invest or divest funds in specific investments on a

continuing basis. For example, the manager might be authorized to transfer funds to a common trust account whenever the checking account cash balance is in excess of a specified balance or average daily need. Again, board policy should state explicitly the authorities delegated to the manager. Under no circumstance should the board or the committee be given an individual carte blanche authority to invest credit union funds.

The board may also delegate to an individual the authority to complete and sign the necessary papers related to investment transactions. The authorization should be sufficiently definitive so that the individual receiving the investment instructions cannot exercise any discretionary powers. Reports of all actions taken under the instructions should be submitted to the board, the investment committee, or the executive committee at least monthly.

During the review of the board and the executive committee policies, the examiner should determine that the board is carrying out its responsibilities and that the proper reports are being rendered if authority has been delegated. The extent of any authority delegated, and to whom, should be outlined clearly in the minutes, and the examiner should become acquainted with any such delegation during each examination.

## 9.2 Audit

The supervisory comittee's annual audit should be reviewed for material deficiencies in the investment area. During the review of the annual audit, the examiner will determine that the committee or the outside auditor completely verified all investments either by physical inspection or by sending confirmation letters, as appropriate. If the supervisory committee has not verified the investments, the examiner should arrange to have the verification done by the committee within a reasonable period, usually 60 days. The examiner will not make a physical inspection or send verification letters unless a problem is suspected, and the inspection or the verification is needed to support an examiner's finding.

## 9.3 Safekeeping

The credit union should have a procedure to ensure safekeeping of its documents.

Examiners should emphasize to the credit union officials the importance of safekeeping investment documents and the strict enforcement of internal controls in order to minimize the possibility of a loss occurring. Investment losses which occur here usually have a material impact on the credit union's financial condition. On occasion, credit unions have been able to recover part or all of such losses, but it usually requires an extended period of time because of the legal process involved.

Each investment document which is held by a third party must be evidenced by a safekeeping receipt. The receipt should contain the following information, as applicable to the type of investment:

(1) Name and identification of the security;
(2) Par value;
(3) Date of issue;
(4) Date of maturity;
(5) Coupon or interest rate; and
(6) Coupon or interest payment dates.

In addition, the credit union should be encouraged to have a "bailment for hire" contract with the safekeeping institution. A "bailment for hire" is a contract in which the credit union pays a third-party institution for safekeeping its securities. This third-party institution keeps the credit union's securities and will deliver only at the request of the credit union. A sample "bailment for hire" contract is included at the end of this section. It also is important for the credit union to receive a periodic statement from the safekeeping institution in order to verify the investments being held by the safekeeping institution.

It should be recommended that investments purchased from a broker be transferred to a third-party institution with which the credit union has a "bailment for hire" contract. This would prevent problems with non-delivery of securities, delivery of the wrong securities, purchase of non-existent securities, and other similar problems.

When documents are held by a broker, the credit union must be assured that the documents are physically segregated from the broker's investments and that the broker maintains separate records for the credit union's investments. The credit union also should have procedures to periodically confirm the investments being held with the broker. The credit union should also review the account agreement entered into with the broker. It should be determined that the credit union has not, by agreement, permitted the broker to lend its securities in the marketplace. It is important that the credit union institute these internal control procedures because, in recent years, losses have been sustained by credit unions that have had securities held by a broker. In one case, a brokerage firm used a credit union's securities as collateral on its own loans and then later entered bankruptcy. In another case, a credit union forwarded funds to a broker but the broker never purchased the security. A "bailment for hire" arrangement could have prevented the latter case. If the credit union chooses to safekeep securities at the broker, the broker's reputation and financial stability should be reviewed in a similar manner as suggested in Investment Policies, Section 9.1.

Credit unions which retain investment documents in a safe deposit box on the credit union premises or in another institution should appoint a custodian. The custodian can be neither an official or an employee. The custodian should not have sole access to the documents or to the accounting records involving the investments.

Regardless of what method or methods are used to control investment documents, the credit union must have procedures in place to periodically inspect and reconcile the actual documents, statements, and safekeeping receipts to the credit union's records.

## 9.4 Records

While all credit unions must maintain adequate investment records, the sophistication of these records will depend on the level of activity and the types of investments involved. For example, a credit union that invests only in a common trust account can maintain this account without a subsidiary ledger. However, credit unions which have a substantial portion of their assets in investments, or which have substantial investment activities, should maintain adequate subsidiary ledgers.

The subsidiary ledger should be a record of all transactions involving that security. The following information should be recorded on each subsidiary investment record:

(1) Name, type, and identification;
(2) Par value;
(3) Date of issue;
(4) Date of maturity;
(5) Dat of purchase and/or sale;
(6) Book value;
(7) Interest or coupon rate;
(8) Coupon or registered status;
(9) Interest payment dates;
(10) Yield;
(11) Current market value (as of each month-end);
(12) Location or safekeeping;
(13) Amortization of premiums or accretion of discount, if applicable;
(14) Current par value (CPV) of pass-through type investments; and
(15) Name of broker, if used for purchase.

The examiner should determine that the credit union's subsidiary ledgers are current, in balance with General Ledger accounts, and that they provide officials with sufficient information to manage their investment needs.

## 9.5 Investment Valuation

At the examiner's discretion, NCUA 2375, Investment Trial Balance, may be completed to assist in the valuation of investments. If the credit union has prepared a trial balance of its investments as of the effective date of the examination, the examiner may use this to determine the market value of investments. If the examiner decides to use the credit union's trial balance, several investments should be test checked to ascertain if the stated market value and/or book balue is accurate. The examiner should then follow the instructions for valuation and footnotes in the General Ledger Review section if the total market value of the investments is less than the book value.

The market values of securities are quoted in 32nd in most publications and by brokers. The following table converts 32nds of 1 percent, used in bond quotations, to decimal fractions for the convenience of the examiner in determining market value.

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 1 | 0.03125 | 9 | 0.28125 | 17 | 0.53125 | 25 | 0.78125 |
| 2 | 0.06250 | 10 | 0.31250 | 18 | 0.56250 | 26 | 0.81250 |
| 3 | 0.09375 | 11 | 0.34375 | 19 | 0.59375 | 27 | 0.84375 |
| 4 | 0.12500 | 12 | 0.37500 | 20 | 0.62500 | 28 | 0.87500 |
| 5 | 0.15625 | 13 | 0/40625 | 21 | 0.65625 | 29 | 0.90625 |
| 6 | 0.18750 | 14 | 0.43750 | 22 | 0.68750 | 30 | 0.93750 |
| 7 | 0.21875 | 15 | 0.46875 | 23 | 0.71875 | 31 | 0.96875 |
| 8 | 0.25000 | 16 | 0.50000 | 24 | 0.75000 | 32 | 1.00000 |

Quotes on these types of securities are always shown with a bid and an ask quote. The examiner will always use the bid quote when determining the current market value of a security. Also, the market value will be determined by applying the bid quote to the CPV/PAR value of the security.

For example: A credit union owns a U.S. Treasury Bond with a face value of $1,000,000 and a book value of $898,000. The bid is 91.4 (91 4/32nds). The market value of the security would, therefore, be $911,250 ($1,000,000 x .91125).

### 9.5-1 U.S. Government Obligations

Account 741 is used to record obligations of the U.S. Government, such as bills, notes, certificates of indebtedness, and bonds issued by the U.S. Treasury. Additionally, securities fully guaranteed as to principal and interest by the U.S. Government, such as Government of Israel 9-3/4% notes due June 30, 1994, are included in this account.

U.S. Treasury issues may be evidenced in printed form, a "definitive Treasury security," or as an entry made on the books of a Federal Reserve Bank, a "book-entry Treasury security." An actual investment document evidences the former; a safekeeping receipt evidences the latter.

### 9.5-2 Federal Agency Securities

Account 742 is used to record obligations, participations or other instruments issued or guaranteed as to principal and interest by Federal agencies as authorized in Section 107(7)(E) of the Act, wholly owned Government corporations designated in Section 101 of the Government Corporation Control Act, and certain other securities cited in Sections 107(7)(E) and (F) of the Act. Federal agency securities are not guaranteed by the U.S. Government but rather may be guaranteed or backed by the agency or instrumentality issuing the security.

> (1) Obligations - - Agency obligations may be short-term notes or long-term debenture bonds. Short-term notes are bearer instruments with a stated interest rate which are paid at maturity with the redemption proceeds. Debenture bonds, sometimes called consolidated bonds, are either bearer or registered instruments. Bearer bonds may have seminannual interest coupons attached. Semiannual interest checks are mailed to the owners-of-record of registered bonds.
>
> (2) Participations - - Participations differ from debenture bonds in that they are backed by specific assets, such as loans, rather than the general assets of the issuing agency. Generally the loans are guaranteed by the U.S. Government or another Federal agency. Participation certificates may be composed of one loan or a pool of loans. Usually, the participation certificate holder receives monthly payments of principal and interest directly from the servicer of the loan, who in turn received those payments from the borrower. Thus the security is know as a "pass-through." If the agency guaranteeing the security insures the timely payment of principal and interest, the security is known as a "modified pass-through."

Participations that do not have a timely payment guarantee are usually classified as secondary participations. Insured student loans (other than those primarily guaranteed by a state or by a private agency), Farmers Home Administration (FmHA) Business and Industrial Loans, and the guaranteed portion of loans guaranteed by the Small Business Administration (SBA) fall into this category.

The credit union should file all the appropriate forms with the insuring agency and have on file written assurance that the secondary participation loans which it has purchased meet all the requirements in the event of default by the borrowers and a resulting need for the credit union to file a claim. Officials should understand the credit union's collection responsibilities under the insuring clauses suppporting the investments in question.

The credit union should ascertain that participation certificates and any other types of "secondary participations" meet the requirements of Sections 107(7)(E) or (F) of the Act and that there are no obstructions that might invalidate the Federal guarantee.

If any of the above investments are found to be deficient technically or found to be in default and claims denied, the credit union should take corrective action, including appropriate financial report disclosure where applicable.

### 9.5-2.1 Ginne Maes

Government National Mortgage Association (Ginnie Mae) modified pass-through securities have been purchased widely by credit unions. Ginnie Maes are backed by a pool of mortgages insured or guaranteed by the Federal Housing Administration (FHA), The Farmers Home Administration (FmHA), or the Veteran's Administration (VA). The government National Mortgage Association (GNMA) guarantees the timely payment of principal and interest to the security holders. The payment is normally received on the 15th of each month and would include a portion of the principal repayment, as well as interest income.

Because Ginnie Maes have the principal repayment feature, it would be difficult to compute the principal and interest due if securities were sold in mid-month. Thus, the securities industry has a policy of selling Ginnie Mae securities based on their current par value (CPV) as of the end of the previous month. This value cannot be determined until approximately the 15th of each month when the amount of principal repayment is determined by GNMA. At that time, GNMA publishes a factor (Ginnie Mae Pool Factor) which is applied to the original par value. Thus, most Ginnie Maes are sold from the 15th to the 20th of each month.

The credit union should properly record principal and interest repayments and properly reflect the outstanding balance of the security. This can be accomplished by reviewing the statements received from either the services of the Ginnie Mae pool or the credit union's broker, as described below.

Credit unions that are registered owners of Ginnie Maes receive an Issuers Monthly Remittance Advice each month. This form usually accompanies the monthly payment and identifies the amount of principal repayment, interest income, and the current par value (the outstanding balance) of the security. If appropriate, the examiner may verify these figures with those on the credit union's books.

Credit unions that own securities in "street name" generally will receive a statement from their broker. The information contained on these statements will vary from broker to broker. Those statements which provide the principal repayment, interest income, and the CPV of the security may be verified against the figures in the credit union's books.

Where a broker's statement does not provide the CPV of the security, the examiner may compute the balance. This can be accomplished in the following manner:

(1) Obtain the original par value of the security from the broker's trade sheet or, where a trade sheet is not available, from the subsidiary ledgers.

(2) Obtain the Ginnie Mae pool factor (the pool factor represents the percentage of principal still outstanding).

(3) Multiply the original par value by the factor to determine the CPV.

(4) Verify the CPV against the figures in the credit union's records.

Example: Suppose a credit union purchased a Gininie Mae modified pass-through security with an original par valueof $1,007,008.33. The Ginnie Mae pool factor is .99703096. In order to determine the current par value of the security, the following calculation is necessary:

| | |
|---|---|
| Original Par Value | $1,007,008.33 |
| Ginne Mae Pool Factor | .99703096 |
| Current Par Value CPV | $1,004,018.48 |

## 9.5-2.2 SBA Guaranteed Loans

In recent years, credit unions have purchased more fixed-rate Small Business Administration (SBA) Guaranteed Loans as secondary participants than any other group of purchasers. Credit unions, like other purchasers, were induced by the relatively high yields of fixed-rate SBA loans. However, since there was no active secondary market for these loans, they had limited marketability. Thus, they served better as a long-term investment than as a liquid asset. During recent years, SBA introduced a variable rate participation loan, which has become popular because the rate on the loan generally adjusts quarterly and is usually pegged to the prime rate. The adjustable rate is perceived to reduce the interest rate risk of the security.

However, SBA loans, whether fixed or variable rate, do not have a consistent average life like pooled securities such as Ginnie Maes, and are subject to immediate repayment, which could result in a loss if purchased at a premium. In addition, there is a "thin market", i.e., not an actively traded secondary market and a limited number of brokers making a primary market in SBAs. Therefore, the premium paid on SBA has ranged from 103 to as high as 109 in recent years.

Example: A credit union purchased a $100,000, 10 percent, 5-year SBA loan at 105. After 1 year, the balance of the loan was $80,000 and the unamortized premium was $4,000. The borrower repaid the loan in full at this point. Since SBA guarantees repayment only at par, the credit union would not be reimbursed for the remaining $4,000 unamortized premium and would have to absorb the loss during the current accounting period.

The credit union should be aware of the dangers of purchasing SBA loans and other secondary participations at high premiums. However, recommendations that a credit union purchase or not purchase these securities should not be made. The decision to purchase securities remains with the credit union's officials.

### 9.5-3 Mutual funds/Common Trusts

Common trust funds and mutual funds are both plans for investing surplus funds in investments authorized under Sections 107(7) and (8) of the Act and Part 703 of the Rules and Regulations. In order to qualify as a legal investment, the fund must be involved only with investment instruments and investment transactions that are authorized by the FCU Act and NCUA's regulations for direct investments by Federal credit unions. A common trust or mutual fund must show that each member has a beneficiary interest in the assets of the fund. In other words, each member owns a pro rata portion of each investment of the fund.

Each participating credit union should receive a statement from the trustee of the fund each month. The statement will show the amount of the credit union's investment, deposits, withdrawals, earnings, and in some cases, deferred gains and losses for the preceding month. The credit union should ensure that the deferred gains/losses are entered into the records in accordance with page 4-65 of the Accounting Manual. The credit union should have in place procedures that require the account to be reconciled monthly to the General Ledger balance.

There are a number of mutual funds, called "load type funds," that have a sales charge component in the public offering price. The total cost to the investor equals the market value of securities plus a "broker" fee. This "load fee" may be added to the book value (acquisition cost) of the investment at the time of purchase. At the end of each accounting period, a federally insured credit union should determine the net asset value of a share in the mutual fund or the common trust and adjust the investment to the lower of cost or market. Adjustments to the book value of the mutual fund or common trust should be recorded to a Valuation for Losses on Investments account, with a corresponding charge to the expense account Provision for Investment Losses. Page 4-64 of the Accounting Manual for Federal Credit Unions provides information on other accounting entries.

### 9.5-4 Credit Union Service Organizations (CUSO)

In recent years CUSOs have become very popular in the credit union industry as a means of providing additional services to members or to other credit unions. However, if the CUSO is not structured and managed properly, it can quickly turn from an asset to a very expensive liability of the credit union operation and ultimately affect the financial condition. Therefore, it is important that during an examination the examiner make a thorough review of the CUSO in which the credit union is involved.

#### 9.5-4.1 Legal Limitations

Federal credit unions are authorized to invest in and make loans to credit union service organizations as defined in Sections 107(5)(D) and 107(7)(I) of the Act. Under this authority a credit union can invest one percent of its unimpaired capital and surplus and lend an additional one percent to a CUSO. If a credit union is involved in more than one CUSO, remember the aggregate of its invesments in or loans to these CUSOs cannot, in total, exceed the 1% limitations of the Act. The NCUA Rules and Regulations establish specific rules and limitations that must be adhered to by a CUSO.

### 9.5-4.2 Examination Procedures

During the examination of a federal credit union that has an investment in or a loan to a CUSO, the examiner must determine that the CUSO is operating within parameters established in the Rules and Regulations and that the credit union's investment or loan to the CUSO(s) is within the limitations prescribed by the Act.

It is important that the examiner determines during the review of the CUSO operation that:

a. The CUSO operation is not adversely affecting the financial condition and operation of the credit union;

b. The credit union has taken the appropriate steps to assure itself that the CUSO is being operated as a seperate entity in order to limit the credit union's risk should the CUSO fail;

c. The board of directors of the credit union is regularly reviewing the operation of the CUSO;

d. The credit union/CUSO are not involved in any insider dealings as described in the Rules and Regulations;

e. The services being offered are within the framework established in the Rules and Regulations; and

f. The CUSO is having a CPA Audit performed annually.

To assist the examiner in reviewing the areas described previously and to collect other important data about the CUSO, NCUA 2391 will be completed during each examination in which a credit union is involved in a CUSO.

### 9.5-4.3 Examination of a Credit Union Service Organization

The Rules and Regulations allow the National Credit Union Administration to review the books and records of a CUSO when deemed necessary. However, an examiner should not make an examination of the CUSO unless it has been determined from the initial review of the CUSO, during the examination of the credit union, that serious problems are present. When it has been determined that serious problems are present, the examiner should still discuss the situation with the supervisory examiner before proceeding with an examination of the CUSO.

### 9.5-4.4 Federally-Insured State-Chartered Credit Union Involved in Credit Union Service Organizations

Federally-insured state-chartered credit unions are not directly required to adhere to the National Credit Union Administration's regulation regarding CUSOs. However, when the Agency conducts an Insurance Review of an insured state-chartered credit union, the examiner must determine if the CUSO is adversely impacting on the financial condition of the credit union. If it is determined that the CUSO is impacting on the financial condition of the credit union, the examiner will report the findings in the report to the regional director. NCUA 2391 should be completed during the review regardless of whether or not problems are found.

In addition, paragraph 8 of the Insurance Agreement requires a FISCU to establish and maintain an Investment Valuation Reserve Account for all loans and investments other than those expressly authorized by the Federal Credit Union Act. FISCU's must set up such an account for non-conforming loans and investments in service corporations.

### 9.5-5 Federal Funds

Section 703.3(f) of the Rules and Regulations authorizes the sale of Federal funds to a bank under the deposit authority in Section 107(8) of the Act.

Federal funds are simply the excess reserves one bank has available to lend to another bank in order for that institution to meet its cash reserve requirements. The maturity on this type of transaction is usually only 1 day, although term Federal funds may be negotiated for a longer period of time. The Federal funds rate is the rate that lending banks charge borrowing banks for the use of the funds. Compared to other money market rates, the Federal funds rate is very volatile especially on Wednesday, which is the last day of the statement week. The funds rate is watched closely as an indicator of the money market, monetary policy, and economic conditions in general because the Federal funds market operates at the center of the money market and the commercial bank system.

Credit union officials must remember that these funds are not insured since they represent borrowed funds by the bank. Since funds usually are transferred by just a phone call and the bank will be relying on the funds being available, it is obvious that the bank will want to evaluate the financial condition of the credit union. In the same light, the credit union should know the financial condition and the reputation of the bank since the funds sold are not insured and, in many cases, will be passed through to other banks to meet reserve requirements.

When a credit union enters into a Federal funds transaction, the credit union itself must transfer the funds to the bank, which agrees to repay the funds. This means that a securities broker cannot handle the arrangements on the transaction, and the credit union cannot receive considerations from a third party in connection with the transaction. The funds may be transferred to the bank by any method, including from an account maintained at the bank by the credit union. An open-end agreement has no specific maturity date but requires repayment on any date that is specified by either the Federal credit or the bank. A Federal funds transaction does not include the transfer of funds to a bank if the funds are credited to a transaction account or a nonpersonal time deposit, which includes certificates of deposit.

Besides selling Federal funds to a bank, a credit union can purchase Federal funds from the bank. Purchasing of funds constitutes a borrowing transaction and is subject to the borrowing limitations of Section 107(9) of the Act.

Particular attention should be given to the methods used by the credit union to transfer funds and to the recordkeeping aspect of accounting for the transfers and the recording of the income or expense involved.

### 9.5-6 Corporate Central Credit Unions

Account 744 is used to record shares, deposits, and certificates of corporate central credit unions. These investments are authorized under Section 107(7)(G) of the Act.

Corporate central credit unions offer daily balance share accounts which can earn dividends comparable to market rates offered by other financial institutions. Credit unions use this account more frequently for short-term investing because of the daily dividend feature. In addition, many corporate centrals also offer accounts for clearing share drafts and credit card activity. Most corporate centrals issue monthly statements because of the extensive activity in these accounts. These statements must be reconciled monthly the same as a bank statement would be.

Credit unions also should reconcile activity in certificates of deposit (CDs). Most corporate centrals offer high-yielding, short-term CDs (30 days); credit unions are continuously rolling them over or purchasing new ones. Some corporate centrals have stopped issuing certificates due to the paperwork involved and instead are simply making paper transfers, thus complicating the accounting for the CDs.

### 9.5-7 Other Credit Unions

Account 745 is used to record shares, deposits and certificates of federally insured credit unions. These investments are authorized by Section 107(7)(H) of the Act.

### 9.5-8 Other Shares, Deposits, and Certificates

Account 746 includes shares, deposits, and certificates in financial institutions other than credit unions which are authorized under Sections 107(7)(D) and 107(8) of the Act. Authorized accounts include:

> (1) Savings and loans Association Shares - Investments in federally insured savings and loan or building and loan associations are evidenced by passbooks, share certificates, or book entry confirmation receipts issued by the associations. Dividends from these investments may be paid by check or added to the credit union's account.
>
> The responsibility for determining the amount and the specific institution in which a credit union invests is that of its board. The examiner should not take exception where investments in a single association exceed the insurance maximum nor should the suggestion be made that funds in excess of the insured amount be withdrawn.
>
> Cash bonuses or merchandise premiums are sometimes received for new investments or certain increases in investments. These may be paid to the credit union or to its officials or employees by the association itself. The examiner should be alert to the possibility of a credit union or its officials or employees having received such bonuses and ascertain that they are reflected on the credit union's records in Account 121, Income from Investments. If the examiner suspects the credit union has earned a bonus dividend or premium but finds no accounting for it, a positive confirmation letter should be sent to the association concerned. A report of the circumstances should be included in the Closed Section.

(2) Time Certificate of Deposit - A time certificate of deposit (CD) may be negotiable or non-negotiable. If purchased from the issuing institution, the credit union normally would physically contact and negotiate with the institution. If so, funds would be transferred directly. The credit union may use the services of a broker or a third party for the purchase of CD's. If the credit union uses the broker as an agent, it should take reasonable steps to protect against potential loss. These steps include, but are not limited to, entering into a written contract, dealing with reputable third parties, evaluating the risk, and using a "bailment for hire" type contract.

The analysis of the soundness of the financial institutions issuing the CD's should not be solely dependent upon that provided by the brokers nor should the credit union rely on the deposit insurance coverage as the basis for the deposit. The credit union should have written inestment policies that address the criteria and the financial analysis that is conducive to sound investment habits.

Federal credit unions are authorized to sell negotiable CDs to a third party before maturity, subject to the appropriate regulations governing the issuing insitution involved.

A credit union is not required to physically hold a CD for safekeeping, even if the CD is negotiable. However, the credit union should be aware of the risks involved when a security dealer holds negotiable CDs or "bearer" securities. The security dealer can wrongfully transfer the instruments to a third party. If the third party purchases these instruments for value, in good faith and without notice of any adverse claim, the third party is deemed to be a "bona fide purchaser" under the Uniform Commercial Code and is entitled to retain possession of the instruments. Also, the credit union runs the risk that the security dealer could become bankrupt or insolvent. The credit union would be entitled to "trace" and to claim its securities or CDs by proving ownership of specific instruments. However, such recourse would be difficult, if not impossible, in the case of negotiable CDs or securities in "bearer" form because these instruments are never registered in the name of the credit union. Finally, if the credit union suffers the loss of a negotiable CD or security due to a dealer's misappropriation or bankruptcy, it is likely that the credit union's surety will not reimburse the credit union for a loss because the surety usually does not consider the security dealer to be a credit union employee. However, the risks must be balanced against the advantages gained in having a security dealer hold negotiable CDs and securities in "bearer" form for safekeeping; namely, the credit union will have liquid investments which can be redeemed immediately.

A Eurodollar deposit is a dollar denominated deposit in either a foreign branch or a subsidiary of a United States bank or in a foreign bank located outside the United States. Credit unions can invest only in foreign branches of parent U.S. banks and only if the parent U.S. bank is one in which a Federal credit union may make a deposit pursuant to Section 107(8) of the Act.

A Yankee Dollar deposit is a dollar denominated deposit in a United States branch or subsidiary of a foreign bank. If the branch or subsidiary is federally insured or operating in accordance with the laws of a sate in which the Federal credit union does business, when a Federal credit union deposit in the branch or subsidiary is authorized pursuant to Section 107(8) of the Act.

Section 703.3(i) authorizes investments in bankers' acceptances issued by Section 107(8) institutions. A bankers' acceptance is a time draft drawn on a bank and represents an irrevocable obligation of the bank. Bankers' acceptances arise in a variety of ways but generally are used initially by a corporate customer of the bank to "pay" for goods and services and are subsequently discounted and traded as money market instruments.

Investments in foreign banks operating branch offices in the United States, which are either insured by FDIC or operating in accordance with the laws of a state where the Federal credit union does business, are legal for credit unions because they are authorized in Section 107(8) of the Act. The Act still limits deposits in insured state banks, trust companies, and mutual savings banks operating in accordance with the laws of the state where the credit union does business.

If the examiner notes exceptions that are correctable, the officials should be given a reasonable period of time to make the corrections. If the exception is not correctible, such as when the CD is obtained from an out-of-state bank which is non-FDIC insured state-chartered, the deposit is illegal, and the officials should be instructed to liquidate is as soon as practical. If a material loss is involved, the examiner should take into consideration maturity and safety of the investment, as well as the financial impact on operations.

(3) Shares or Accounts in Mutual Savings Banks - Deposits or investments may not be made in mutual savings banks located outside the state in which the credit union does business unless such banks are insured by the Federal Deposit Insurance Corporation (FDIC). Those mutual savings banks that are located within the state in which the credit union does business qualify as depositories even though such insurance is not carried.

The selection of mutual savings banks and the decision on the amount to be deposited in each bank are the responsibilities of the board of directors. The examiner may wish to discuss with the officials the advantages of placing funds in insured savings banks but no exception should be taken if funds are placed in non-insured mutual savings banks which are within the state in which the credit union does business. The examiner may discuss the maximum amount of FSLIC or FDIC insurance currently in force but should take no exception if more than that amount is deposited in a single mutual savings bank.

### 9.5-9 Loans to Other Credit Unions

Account 747 is used to record loans made to nonmember credit unions. Loans made to credit unions that are members (as in the case of loans to members of a corporate central credit union) must be recorded in Account 701, Loans, and must comply with the limitations and restrictions set forth in the Act and the Rules and Regulations.

The board, the executive committee, or the investment committee of the credit union must properly authorize the loan. The aggregate of such loans may not exceed the legal limit, and a signed note must be on file. Other supporting documents should be on hand, as required by appropriate sections of the Rules and Regulations. When the credit union has not met these requirements, the officials should be advised, appropriate agreements should be reached, and comments should be placed in the appropriate section of the examination report.

### 9.5-10 Allowance for Losses on Investments

The use of Account 759, Allowance for Losses on Investments, is strictly voluntary on the part of Federal credit unions for securities that have a stated par value, stated maturity date, and are expected to be held to maturity. The officials should be aware of the advantages of using this account to record potential losses on investments they intend to liquidate.

The Allowance for Losses on Investments will be used to record adjustments made to common trust or mutual fund investments at the end of each accounting period using the required lower of cost or market approach. To record a decline in value, a corresponding charge to the expense account, Provision for Investment Losses, will be made.

### 9.5-11 State and Municipal Obligations

Account 753 includes investments in state and municipal securities which are authorized in Section 107(7)(k) of the Act. Generally, obligations of this type are limited to 10 percentum of unimpaired capital and surplus for any one issuer. An exception exists when the issuance is a general obligation of the issuer, i.e., the obligation will be retired from the tax revenues as opposed to other resources.

State and municipal obligations generally are issued at lower interest rates because of a unique tax advantage to security holders. Since credit unions doe not pay income taxes, this advantage may limit their participation in state and municipal securities.

### 9.5-12 Repurchase Transactions

Section 703.3(d) of the Rules and Regulations authorizes credit unions to enter into investment-type, financial institution-type, and loan-type repurchase transactions. Each type of transaction is permissible for Federal credit unions within the limitations established below:

(1) Investment-Type Transaction - This transaction represents a bona fide purchase of a security by a credit union. Generally, investment-type repurchase transactions are short-term purchases and resales of securities; the credit unions should be sure that:

(a) All the elements of a sale exist, i.e., there is no restriction on the transfer of the security, and the credit union is not required to redeliver the same security does not in and of itself mean at the transaction does not qualify as a permissible invesment activity. The examiner should determine that the credit union could substitute the purchased security with a similar security.

(b) The underlying security is a permissible investment for a credit union.

(c) The credit union takes physical possession of the security or has it deposited in a third-party safekeeping account evidenced by a safekeeping receipt under "bailment for hire" contract. The examiner may wish to review the credit union's file to determine that it contains a written "bailment for hire" contract as well as copies of the safekeeping receipts. A trust department of the same bank that is offering the repurchase transaction would qualify as a third party and may hold the underlying securities on behalf of the credit union, provided that there is a written "bailment for hire" contract between the trust department and the credit union. Or, the credit union could be recorded as owner of the security through the Federal Reserve Bank - Entry System.

(d) The security purchased is recorded in the appropriate investment account and that the other accounting procedures outlines on page 6-73 of the Accounting Manual are followed.

(2) Financial Institution-Type Repurchase Transaction - A credit union may engage in repurchase transactions with other financial institutions without regard to the distinction between loan-type and investment-type transactions. Since the authorization originates from the deposit authority, the financial institution must be an FCU Act Section 107(8) institution.

(3) Loan-Type Repurchase Transactions - This transaction represents any repurchase transaction that does not qualify as a investment-type or financial institution-type repurchase transaction. As such, the transaction is a loan secured by collateral. Federal credit unions are restricted in this activity to loans to members, other credit unions, and credit union organizations. The former will be reviewed under the appropriate subsections to this section of the Guide.

## 9.6 Commitments to Purchase/Sell Securities

NCUA 2380, Commitments to Purchase/Sell Securities, may be prepared when credit unions have outstanding commitments to purchase or to sell securities via a forward agreement. The examiner should be able to obtain the information needed from the original source documents. However, in the event the original source documents are not available, subsidiary ledgers may be used. In these cases, firm agreements to obtain or to replace the original source documents should be obtained, and the supervisory committee should confirm the commitments.

## EXAMINER'S GUIDE

Forward commitments represent a contingent liability and, thus, should be footnoted on the Statement of Financial Condition. It is possible that outstanding commitments may exist and not be footnoted, so the examiner should question the appropriate officials or employees to determine if additional commitments do exist.

The types of commitments that may be found in a credit union are:

(1) Standby Commitment - A standby commitment is an agreement to purchase or to sell a security at a future date, whereby the purchaser is required to accept delivery of the security at the seller's option. To induce the purchaser to buy at the seller's option, the seller pays a "commitment fee" which is nonrefundable. If the market price of the security on settlement date has increased, the seller would not exercise the option but would sell the security elsewhere. The purchaser would then recognize the "commitment fee" as income. However, if the market price decreases, the seller will sell the security to the committed purchaser. The purchaser of a standby commitment is at a definite disadvantage in a down market since the security delivered would be valued at less than the purchase price. Standby commitments to purchase or to sell securities are prohibited for Federal credit unions by Section 703.4(a) of the Rules and Regulations.

(2) Cash Forward Agreement - A cash forward agreement is a firm commitment for a purchaser to buy and a seller to sell an agreed-upon security on a specified settlement date. A commitment fee is not passed from the seller to the purchaser.

Federal credit unions may not purchase securities by use of cash forward agreements that extend beyond 120 days from the trade date. Additionally, Federal credit unions must have written cash flow projections evidencing their ability to purchase the securities on the settlement date. The examiner should use discretion in reviewing the cash flow projections. If the credit union commits to purchase a security and intends to fund it with a certificate of deposit that matures the same day, it would be acceptable if the credit union so notes its intent on the commitment document. If the credit union intends to use future share deposits to fund the purchase, the projections must be detailed.

Cash forward agreements must be settled in cash; therefore, they may not be extended or rolled over.

The credit union should record securities purchased by use of a cash forward agreement at the lower of cost or market at settlement. In addition, the accounting procedures outlined on page 6-72 of the Accounting Manual should be followed.

(3) Short Sale - A short sale is a forward commitment to sell a securiy that is not owned. The intent in making short sales is to speculate that market prices will decline prior to settlement date. Thus, a less expensive security can be purchased to meet the commitment to sell and a gain would result. If, however, the market price increases, a loss is incurred in meeting the commitment. Short sales represent a speculative activity which is not permitted for Federal credit unions by Section 703.4(d) of the Rules and Regulations.

(4) Pair-Off Transactions - A pair-off transaction is the matching or netting of commitments to purchase and to sell securities via cash-forward agreements. Generally, a Federal credit union would commit to purchase a security on the same settlement date. The purpose in engaging in pair-off transactions is not to take delivery of the security purchased but to speculate that the market price will increase before settlement date, and a gain will result from its sale. Many times, the commitment to sell is made the same day as the commitment to purchase. Pair-off transactions are prohibited by Section 703.4(c) of the Rules and Regulations, which prohibits Federal credit unions from selling securities they do not own via a cash-forward agreement.

### 9.7 Reverse Repurchase Transactions

NCUA 2385, Reverse Repurchase Transactions, may be prepared to analyze reverse repurchase transactions outstanding as of the effective date of the examination.

A reverse repurchase transaction (reverse repo) is a loan to a credit union collateralized by an asset which is usually a marketable security. Brokers describe a reverse repo as the "sale" of a security by a credit union with an agreement to "repurchase" the same security in the future.

The funds generated by a reverse repo may be used to meet liquidity needs, such as share or loan demands, or to purchase other securities with a better yield than the securities collateralized. When engaging in the latter, the credit union must comply with the limitations established in Section 703.3(e) of the Rules and Regulations. The regulation permits a credit union to enter into a reverse repurchase transaction, provided that either any security purchased with the funds obtained from the transaction or the securities collateralizing the transaction have a maturity date not later than the settlement date for the reverse repurchase transaction. A reverse repurchase transaction is a borrowing transaction subject to Section 107(9) of the FCU Act, which limits the credit union's borrowing to 50 percent of its unimpaired capital and surplus.

Example: A credit union owns a $4,097,000 Ginnie Mae modified pass-through security with an 8 percent coupon rate, valued at par. The credit union enters into a reverse repo, borrowing $1 million at 5-1/2 percent for 90 days. The credit union also purchases a 90-day time certificate paying 6 percent, also maturing in 90 days. Thus, the credit union earns a 1/2 percent arbitrage (the difference between the cost of the funds borrowed, 5-1/2 percent, and the income earned, 6 percent).

Many times, credit unions enter into a reverse repurchase transaction assuming that by reinvesting the funds they will earn a positive arbitrage, but this may not always be true. In the example above, the credit union would have received income of $15,000 while paying $13,750 in interest on the borrowed funds. At this point, the credit union shows a positive arbitrage of $1,250; but, if the credit union was in a 10 percent reverse transfer position, it would then have to reserve 10 percent of the $15,000, or $1,500. Therefore, the transaction actually resulted in a negative earnings of $250 for the credit union ($1,500 - $1,250 = $250). If the examiner finds a credit union entering into reverse repurchase transactions with the intent of earning a positive arbitrage by reinvesting the funds, the examiner should determine if a positive arbitrage is actually being realized.

Reverse repos generally are not supported by individual written agreements between a broker and the credit union. They are evidenced by a trade sheet.

Since reverse repos represent borrowing by the credit union, they must be recorded as notes payable and must be approved by the board of directors or an executive committee. The investment committee cannot authorize borrowing via a reverse repo.

The credit union must properly record reverse repos, the income applicable to the related investment, and the interest on the notes payable.

### 9.8 Purchase/Sales Analysis

When reviewing investments in Accounts 741 and 742, the examiner should be looking for any indications that during the examination period the credit union purchased or sold securities at prices that were not "at market." The examiner should test check several purchases or sales if there are any indications that a security transaction was not at market. The examiner can determine the sales price by verifying it in the Wall Street Journal or in another reliable paper as of the date of the sale or by contacting a broker. If there is a problem and one of the following conditions exist, the examiner should make an in-depth analysis:

(1) The broker/dealer is not regional, i.e., one whose office of operations is not located within close proximity to the credit union; or

(2) The broker/dealer does not enjoy a reputation of knowing its customers or of providing suitable investments to its customers.

The purchase and the sale of securities which are off market are indicators that the credit union may be involved in adjusted trading. Adjusted trading is a violation of Section 702.3 of the Rules and Regulations in that "full and fair disclosure" requirements are not met and losses are not recorded in a timely manner. As a result of adjusted trading, the credit unions has not fairly presented its financial condition to its members, its creditors, and the NCUA Board. Section 703.4(c) of the Rules and Regulations prohibits Federal credit unions from engaging in adjusted trading.

The two most common methods of adjusted trading are:

(1) Adjusted Trading/Overtrading - Due to declining market prices, credit unions may face investment losses if they must sell securities already owned or must meet commitments to purchase securities when funds are not available. To avoid these losses, it is not permissible for a credit union to enter into an agreement with its broker to transfer or to hide the loss in another transaction. This activity, known as adjusted trading or overtrading, would operate as follows:

The credit union owns investment A with a book value of 97 and a market value of 95. The broker owns Investment B with a market value of 91.

Needing funds, the credit union decides to sell security A but does not wish to incur a loss; in this case, two (2) points. The broker agrees to purchase the investment a book value, 97; however, in return, the credit union agrees to purchase security B via a forward commitment for 93 or two (2) points "over market."

The credit union is speculating that the market value of security B will increase by settlement date; thus, no loss would be recorded on the credit union's records.

## 9.9 Illegal Investments

The examiner may find that a credit union has investments which do not comply with Sections 107(7) or 107(8) of the Act, such as accounts in nonfederally insured savings and loan or building and loan associations; non-insured, out-of-state mutual savings banks; or loans to other credit unions in excess of the legal limitations. The examiner should instruct the board to liquidate the investments as soon as practicable. If a material loss is involved, the examiner should take into consideration the maturity and the safety of the investment, as well as the impact on the financial condition. In these cases, the examiner's supervisor should be consulted for guidance. The credit union should also notify the surety company that an illegal investment had been purchased.

In most cases the problem can be resolved during the examination. If this is not the case, a Record of Action will be developed and comments provided in the Closed Section of the Report. Administrative action can and should be utilized only in those extreme cases where the credit union officials do not respond to the other supervision efforts.

## 9.10 Workpapers and References

(1) Workpapers

(a) NCUA 2055, Examination Checklist
(b) NCUA 2141, Closed Section
(c) NCUA 2375, Investment Trial Balance
(d) NCUA 2380, Commitments to Purchase/Sell Securities
(e) NCUA 2385, Reverse Repurchase Transactions
(f) NCUA 2390, Investment Internal Controls
(g) NCUA 2395, Investment Supplement

(2) References

(a) Federal Credit Union Act
  (i) Sections 107(7), 107(8), and 107(9) - Powers

(b) NCUA Rules and Regulations
  (i) Part 703 - Investments and Deposits

(c) Accounting Manual for Federal Credit Unions - Pages 4-60 thru 4-70 and Pages 6-70 to 6-82.

(d) Administrator's letter No. 29, dated 4/17/79; Custodial/Safekeeping Accounts

(e) NCUA Letter No. 57, dated 6/24/81, Investment Risk

(f) NCUA Letter No. 79, dated 5/29/85, Mutual Funds

(g) NCUA Investment Hotline - 1-800-324-3205

## 9.11 Glossary of Investment Terms

ACTUAL. The physical or cash commodity, as distinguished from commodity futures contracts based upon the commodities. When forward contracts trade for immediate delivery, they become actuals. Actuals are also called spot commodities or cash commodities.

ADJUSTED TRADING. A method of deferring or hiding a loss on the sale of a security. Generally, a security is sold at its book value, which is above the market value, and another security is purchased or a commitment is made to purchase another security at a price that is also above the market value.

ADVANCE COMMITMENT (CONDITIONAL). A written promise to make an investment at some time in the future if specified conditions are met.

AMEX COMMODITIES EXCHANGE (ACE). The commodities exchange affiliate of the American Stock Exchange (AMEX).

AMORTIZATION. Gradual debt reduction. The reduction is usually made according to a predetermined schedule for installment payments.

ARBITRAGE. The difference between the cost of borrowed funds and income received on an investment in a reverse repurchase transaction.

(1) Positive Arbitrage: When income on an investment is greater than the cost of borrowed funds.

(2) Negative Arbitrage: When the cost of borrowed funds exceeds the income received on an investment.

ASKED. The lowest declared price that a seller will accept for a security at a particular time. Opposite of Bid. See also Offer.

ASSIGNMENT. The transfer of a right or a contract from one person to another.

AT MARKET. The going bid price of a security at any given time.

AUCTION. The process by which an issuer sells its securities.

BACKUP BID. See Take Out Bid.

BAD DELIVERY. A delivery of securities that does not fulfill the requirements for good delivery.

BAILMENT FOR HIRE. A safekeeping agreement between a safekeeping institution and its customer.

BANKER'S ACCEPTANCES. A negotiable letter of credit (loan), usually issued by a foreign financial transaction.

BASIS. The yield to expected maturity, as in the expression "Ginnie Maes are trading on a 9-1/2% basis." Basis also means the relationship of a cash market price to the commodity. Basis is usually computed to the near future and may represent different time periods, product forms, qualities, and locations. Basis is also used in the phrase "long the basis" or "short the basis" to indicate a cash market trade hedged with a futures trade. See Long the Basis and Short the Basis.

BASIS POINT. A measurement of yield for fixed income securities. One basis point equals 1/100 of 1 percent.

BID. The highest declared price a buyer is willing to pay for a security at a particular time.

BID and ASKED. Often referred to as a quotation or a quote. See also Quotation, Take Out Bid.

BOARD OF TRADE. An exchange or an association of persons, whether incorporated or unincorporated, which is engaged in the business of buying and selling any commodity or receiving the same for sale on consignment.

BROKER. An agent who does not actually own the securities which are bought or sold. A broker, as contrasted to a dealer, is always acting on behalf of another, usually unidentified principal. A broker charges a commission for services rendered.

CALL. An option contract which entitles the holder to buy (call), entirely at the holder's option, a specified quantity of a security at a specified price at any time until the stated expiration date of the contract or at a specified time. Such an option is bought in the expectation of a price rise above the contract price. If the price rise occurs, the purchaser will exercise the option. If the rise does not occur, the purchaser will let the option expire and will lose the cost of the option.

CALL FEATURE. A provision on a bond which entitles the issuer to redeem the bond at face value or other price before the maturity date.

CALL LOAN. A short-term loan of temporarily liquid funds by banks to securities dealers and brokers.

CASH COMMODITY. See Actuals.

CASH FLOW. The spendable income from an investment after subtracting from gross income all operating expenses. The amount of cash derived over a certain measured period of time from the operation of income-producing property after debt services and operating expenses but before depreciation.

CASH FORWARD AGREEMENT. A commitment to purchase/sell a security at a future date that is binding on both the buyer and the seller. Also known as a firm or firm commitment. See Commitment.

CASH MARKET. A market in which transactions for purchase and sale of the physical commodity are made under whatever terms are agreeable to buyer and the seller and are legal under law and the rules of the market organization, if such exists. Cash market can refer to an organized, self-regulated central market, such as the cash grain sections of commodity exchanges that also have futures contract trading, or such as the bond section of a stock exchange. It can also refer to an over-the-counter type of market in which buyers, sellers, and/or dealers compete in decentralized locations, possibly under rules of an organized association. In still other uses, the term may refer to such other methods of purchasing and selling the physical commodity as are prevalent in the industries using that commodity. The cash market for Ginnie Maes refers to a group of recognized dealers, such independent buyers or sellers as the party can find, or to a mixture of both, depending upon the circumstances in which the term is used. See also Spot and Forward.

CASH PRICE. A price quotation obtained or a price actually received in a cash market. Same as Spot Price.

CATS. See Zero Coupon Treasury Bond.

CHEAP. Wall Street vernacular for the relative value of one security to another in terms of its historical price relationship. If a security is cheap, it is underpriced relative to another security. See also Rich.

CHICAGO BOARD OF TRADE (CBOT). An exchange which maintains markets in commodities and futures contracts. The CBOT introduced GNMA futures contracts in 1975 and provides a futures market for Ginnie Mae securities.

CHURNING. The processing of unnecessary purchases and sales in customers' accounts for the purpose of generating commissions.

CLEARANCE. The act of clearing securities between buyers and sellers. Receipt or delivery of securities against payment.

CLEARANCE CORPORATION. A corporation organized to function as the clearing house for an exchange. Its purpose is to centralize the delivery of securities, and it may also interpose itself as the contra party to all transactions made by its members. Also called Clearing house.

CLEARANCE ORGANIZATION. Usually a brokerage concern which clears the transactions of another brokerage concern.

CLEARING MEMBER. A brokerage concern entitled to use the services of the clearing corporation.

CLOSE POSITION. Forward or futures contracts which have been offset in full are considered "closed" because the obligations cancel each other out.

CLOSING PRICE. The price at which transactions are made just before the end of trading on a given day. On a futures exchange, there is frequently no one closing price but a range of closing prices at which transactions were made just before the bell. See also Settlement Price.

COMMERCIAL PAPER. A short-term unsecured promissory note issued by a corporation for a maturity specified by the buyer.

COMMITMENT. An agreement to buy/sell a security at a future date, subject to compliance with stated conditions. Applies to mortgage-backed securities. See Cash Forward Agreement, Standby Commitment, and Take Out Commitment.

COMMITMENT FEE. See Fee.

COMMODITY EXCHANGE, INC. (COMEX). A commodities exchange.

COMMODITY FUTURES TRADING COMMISSION (CFTC). A Federal regulatory agency charged and empowered under the Commodity Futures Trading Commission Act of 1974 with regulation of futures trading in all commodities.

COMMON TRUST. A fund established by a national bank in which collective surplus funds are invested in investments authorized by Section 107(7) of the Act.

CONNIE MAC. A colloquial term for securities collateralized by pools of conventional mortgages. See Conventional Loan.

CONTRACT. A term of reference describing a unit of trading for a commodity for future delivery. Also an actual bilateral agreement between buyer and seller.

CONTRACT GRADES. Those grades of a commodity which have been officially approved by an exchange as deliverable in settlement of a futures contract.

CONTRACT MARKET. A board of trade designated by the Commodity Futures Trading Commission as a contract market under the Commodity Exchange Act. Sometimes a commodity, the contract for which is approved for futures trading, as in "Ginnie Maes are a contract market."

CONTRACT MONTH. The month in which delivery is to be made in accordance with a futures contract.

CORRESPONDENT. A mortgage banker who services mortgage loans as a representative or an agent for the mortgage owner or investor. Also applies to the mortgage banker's role as originator of mortgage loans for an investor.

COUPON. The rate of interest paid on a security. See Rate of Interest.

COUPON INCOME. The income received from the coupon rate on owned securities.

COUPON RATE. See Rate of Interest.

COVER. Purchasing to offset a short position. Same as Short Covering. See Offset, Liquidation, Evening Up.

COVER VALUE. The monetary amount necessary to buy-in a short position at the current market value.

CROSS HEDGE. A hedge with two transactions in different, but related, securities, usually in different markets; for example: a long position in U.S. Treasury Bonds in the futures market and a short position in the Ginnie Mae forward market.

CURRENT MARKET VALUE. The closing price of a security as of the preceding business day.

CURRENT YIELD. Yield arrived at by dividing the coupon by the security price or the cost. Often referred to as current return.

CUSTODIAN. An individual or organization responsible for safeguarding securities of another party. With regard to GNMA securities, when the specified amount of mortgages has been accumulated in a pool, the mortgages are submitted to an approved custodian (usually a commercial bank) which examines them. After examination and appropriate certification, GNMA issues its guaranty of the mortgage-backed security.

DEALER. An individual or firm in the securities business acting as a principal rather than as an agent. Typically, dealers buy for their own accounts and sell to customers from their own inventory. The dealers' profits or losses are the difference between the price they pay and the price they receive. The dealers' confirmations must disclose to their customers that they have acted as principals. At different times, the same individual or firm may function as either broker or dealer.

DEALERS ASSOCIATION. See Mortgage-Backed Securities Dealers Association.

DEFERRED FUTURES. The futures of those currently traded that expire during the most distant months.

DELIVERABLE GRADES. See Contract Grades.

DELIVERY. The tender and receipt of a security in settlement of a trade. Delivery has unique connotations when used in connection with futures contracts. Basically, in such usage, delivery refers to the changing of ownership of control of a commodity under very specific terms and procedures established by the exchange upon which the contract is traded. For example, typically the commodity must be placed in an approved warehouse (bank, in the case of Ginnie Macs) after which the facility issues a warehouse receipt (Collateralized Depositary Receipt, in the case of Ginnie Maes; financial receipt, in the case of commercial paper), which becomes a transferable delivery instrument. In the case of a cash or forward trade, the delivery is the tendering of the securities to the purchaser against receipt of payment at the contract price.

DELIVERY MONTH. A calendar month during which delivery against a futures contract can be made.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT (HUD). A department of the U.S. Government. GNMA is a corporate instrumentality within HUD.

DEPOSITORY. An organization which accepts securities for deposit. A depository facilitates the delivery between members by making accounting entries reflecting ownership rather than by the actual movement of securities.

DISCOUNT. An amount, expressed as a percentage, that a security is trading below its par value (e.g., a 6% discount would mean that a Ginnie Mae was selling at a price of 94% of par or 6% less than par). Some securities, especially Treasury Bills, are issued at a discount and are redeemable at par when they reach maturity. The difference between the original discount and par provides the rate or return on the investment.

DISINTERMEDIATION. The phenomenon that occurs when the rates being paid by certain financial intermediaries cannot compete with the rates being paid by others (e.g., the U.S. Government on its Treasury Bills). This causes a shrinkage in the amount of deposits held by those financial intermediaries which are unable to pay the higher rates. See also Intermediation.

DOLLAR PRICE REPO. The sale of a security and the commitment to purchase another.

DOMINO EFFECT. The chained impact of a default by one organization on other firms in the securities industry.

DUE BILL. A promissory note delivered to a customer by a broker or a dealer which states that the holder is entitled to dividends, rights, etc., or a security. At a later date, the broker delivers the distribution or security to the customer to replace the due bill. The CDR under the original CBOT contract is also commonly called a due bill.

ELIGIBILITY. See Legal Eligibility.

ENDORSEMENT. A writing on a negotiable instrument by which title to property mentioned therein is assigned and transferred. A notation added to an instrument after execution to change or to clarify its contents.

ESCROW AGENT. A third party, acting as an agent for the buyer and the seller, carries out the instruction of both and assumes the responsibilities of handling the paperwork and the disbursement of funds.

ESCROW FEES. Fees charged by the escrow holder for services.

EURODOLLARS. Eurodollars are foreign, interest bearing deposit liabilities denominated in dollars.

EVENING UP. Buying or selling to offset an existing market position. See Liquidation.

EXCHANGE. An organization which maintains a market by bringing together members to execute trades in the commodities or securities listed on the exchange. Also called a Board of Trade in the commodities markets.

EXCHANGE OF CASH FOR FUTURES. A transaction in which the buyer of a cash commodity transfers to the seller a corresponding amount of long futures contracts or receives from the seller a corresponding amount of short futures, at a price difference mutually agreed upon. In this way, the opposite hedges in futures of both parties are closed out simultaneously. Also called Exchange for Physical or Against Actuals.

EXEMPT SECURITIES. Securities exempted from registration under the Securities Exchange Act of 1934, other than by action of the Securities and Exchange Commission.

EXERCISE PRICE. The price at which the buyer of a call can purchase the commodity or the security at the expiration of the option and the price at which the buyer of a "put" can sell. Also called Strike Price.

FACE VALUE. The value of a bond or similar security that appears on the face of the certificate. Ordinarily, the amount the issuer promises to pay at maturity. Face value is not an indication of market value. Sometimes referred to as par value. Refers to the original principal amount of mortgage-backed securities.

FACTOR. In the trading of Ginnie Mae securities, the principal amount of each outstanding certificate is reduced monthly by its pro rata share of the regular mortgage payments by the mortgagees of the underlying mortgages and any prepayments or foreclosures. GNMA issues a list of factors each month which expresses, in decimal terms (e.g., .937524), the outstanding remaining percentage of principal amount of each pool. The Ginnie Mae security holder may, thus, calculate the amount of principal paid that month by multiplying the factor by the original principal amount of the certificate.

FAILS. Security transactions between two brokerage concerns which are past settlement date but have not yet been settled.

FANNIE MAE. See Federal National Mortgage Association (FNMA).

FARMERS HOME ADMINISTRATION (FmHA). A U.S. Government agency established under the Farmers Home Administration Act of 1946 to provide financing to farmers and other qualified borrowers who are unable to obtain loans elsewhere. It makes, participates in, and insures loans for rural housing and other purposes.

FEDERAL FUNDS. The excess reserves one financial institution has available to lend to another financial institution in order to meet its cash reserve requirements. Also refers to money which has immediate value, usually represented by a check drawn on a Federal Reserve Bank by a member or by the Treasury.

FEDERAL HOME LOAN MORTGAGE CORPORATION (FHLMC). A private corporation authorized by Congress. FHLMC is a secondary-market facility of the FHLBB system. It sells primarily, mortgage participation certificates secured by pools of conventional mortgage loans whose principal and interest are guaranteed by the Federal Government through the FHLMC. It also has sold GNMA bonds to raise funds to finance the purchase of mortgages. Popularly known as Freddie Mac.

FEDERAL HOUSING ADMINISTRATION (FHA). A division of HUD. Its main activity is the insuring of residential mortgage loans made by private lenders. It sets standards for construction and underwriting. FHA does not lend money or construct housing.

FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA). A taxpaying corporation created by Congress to support the secondary mortgage market. It purchases and sells residential mortgages insured by FHA or guaranteed by VA, as well as conventional home mortgages.

FEDERAL OPEN MARKET COMMITTEE (FOMC). The arm of the Federal Reserve System (Fed) that controls the purchase and sale of U.S. Government Securities for the Fed.

FEE.

(1) Commitment Fee: A payment to investors or prospective investors, which may or may not be refundable, for the purpose of obtaining a commitment to purchase or to sell securities.

(2) Standby Fee: A nonrefundable amount received or paid for the sale or purchase of a standby commitment.

(3) Up-front Fee: A commitment fee paid in advance of the settlement date to an investor for a future purchase.

FEE TRADING. See Adjusted Trading.

FINANCIAL INSTRUMENTS. Any obligation or contract which can be negotiated, including stocks, bonds, commercial paper, forwards, and futures.

FINANCIAL INTERMEDIARY. A financial institution which acts as an intermediary between savers and borrowers by accepting money from the public and, in turn, by lending the accumulated funds to borrowers. The classification includes savings associations, commercial banks, mutual savings banks, life insurance companies, and credit unions.

FIRM COMMITMENT. A cash forward agreement.

FLOOR BROKER. Any person who, in or surrounding any pit, ring, post or other place provided by an exchange for the meeting of persons similarly engaged, executes for others any orders for the purchase or the sale of any commodity or security and receives a prescribed fee or commission.

FORECLOSURE PAYMENT. A prepayment made to holders of mortgage-backed securities from proceeds of property liquidation after foreclosure. Amount of prepayment must equal the principal balance of the foreclosed mortgage.

FORWARD. A cash market transaction in which two parties agree to the purchase and the sale of a commodity at some future time under such conditions as the two agree. In contrast to futures contracts, the terms of forward contracts are not standardized. A forward contract usually is not transferable and can be cancelled only with the consent of the other party, which often must be obtained for consideration and under penalty, and forward contracts are not traded in federally designated contract markets. Essentially, forward contract refers to any cash market purchase or sale agreement for which delivery is not made "on the spot." See Commitment, Cash Forward Agreement, and Standby Commitment.

FORWARD CONTRACT. See Forward.

FORWARD MARKET. Refers to informal (nonexchange) trading of commodities to be delivered at a future date. Contracts for forward delivery are not standardized, i.e., delivery time and amount are as determined between seller and customer.

FORWARD MONTHS. Futures contracts, or those currently traded, calling for later or distant delivery. Also described as Deferred Futures.

FREDDIE MAC. See Federal Home Loan Mortgage Corporation (FHLMC).

FUNDING DATE. Term used by mortgage bankers to denote the date on which the mortgage banker funds or finances a new issue of Ginnie Maes. See Settlement Date.

FUNGIBILITLY. The characteristic of interchangeability. Futures contracts for the same commodity and delivery month are fungible due to their standardized specifications for quality, quantity, delivery date, and delivery locations. Ginnie Maes bearing the same interest rate are fungible until pool numbers are assigned. Subsequently, fungibility may decline or vanish.

FUTURES. Option contracts sold on an exchange or board of trade in which the terms are standardized.

FUTURES COMMISSION MERCHANT. Individuals, associations, partnerships, corporations, and trusts engaging in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on, or subject to, the rules of any futures exchange.

FUTURES EXCHANGE. See Contract Market.

FUTURES PRICE. The price of a given commodity unit determined by public auction on a futures exchange.

GINNIE MAE MORTGAGE-BACKED SECURITIES (OR GINNIE MAES). Securities guaranteed by GNMA and issued by mortgage bankers, commercial banks, savings and loan associations, savings banks, credit unions, and other institutions. The Ginnie Mae security holder is protected by the full faith and credit of the U.S. Government. Ginnie Mae securities are backed by FHA, VA, or FmHA mortgages. The term "pass-throughs" is often used to describe Ginnie Maes.

GO-AROUND. The technique whereby the manager of the System Open Market Account purchases and sells securities for the Federal Reserve System.

GOOD DELIVERY. A security which is in proper form to comply with the terms of the contract of sale.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA). On September 1, 1968, Congress enacted legislation to partition FNMA into two continuing corporate entities. GNMA assumed responsibility for the special assistance loan program and the management and liquidation functions of the older FNMA. GNMA also administers and guarantees mortgage-backed securities, which channel new sources of funds into residential financing through the sale of privately issued mortgage-backed securities.

GROSS LONG. The gross long position is the total of open long contracts in the open position without taking into account any short positions held at the same time.

GROSS SHORT. The gross short position is the total of open sales contracts made by an investor or a speculator in Ginnie Maes, not reduced by any long contracts owned at the same time.

GUARANTY. A promise by one party to pay a debt or to perform an obligation contracted by another party in the event that the original obligor fails to pay or perform as contracted.

HAIRCUT. Deductions from net worth of certain specified percentages of the market value of securities and long and short futures contracts in the capital and proprietary accounts of a broker or a dealer. These deductions are solely for the purpose of computing net capital and are not entered on the books.

HEDGE. Two or more contemporaneous transactions in the same (or similar) securities or commodities in which the risk of price movement is believed by the initiator (hedger) to be reduced or changed. Hedging is common in futures, forward, and options trading strategies. A typical hedge might be for a speculator or a investor to buy a security for delivery 3 months away at a specified price and to sell the same security at another price for forward delivery 6 months away. The investor who makes such a transaction believes that the shorter or nearby contract will rise in price more rapidly than the longer contract. The potential profit is the difference in prices from the original, or opening, transactions and the final, or closing, transactions. Other typical hedges involve taking an opposite position in the futures market to a position held in the cash market to minimize the risk from adverse price changes and taking a position in the futures market as a temporary substitute for a cash transaction that will occur later. Another type of hedge is for the producer of a commodity, such as a mortgage banker (who "produces" mortgages which will be converted into Ginnie Mae pass-through securities), to make financial commitments to the mortgagee now and guarantee a profit on the transaction by selling contracts to deliver Ginnie Mae pass-through securities at a future date when they become available.

HIT. A trader's bid price.

HUD. The Department of Housing and Urban Development. Established by the Housing and Urban Development Act of 1965 to supersede the Housing and Home Finance Agency. Responsible for the implementation and administration of government housing and urban development programs. HUD programs include community planning and development, housing production, the extension of mortgage credit (FHA), and ensuring equal opportunity in housing.

IMPOUND. See Escrow Payment.

INITIAL MARGIN. The amount of money or its equivalent that a customer must deposit with a broker when the customer buys or sells a security or futures contract on margin.

INSTITUTIONAL LENDER. A financial institution that invests in mortgages and carries them in its own portfolio. Mutual savings banks, life insurance companies, commercial banks, pension and trust funds, and savings and loan associations are examples.

INSURED ASSOCIATION. A savings association with savings accounts insured by FSLIC.

INTEREST RATE. See Rate of Interest.

INTEREST TRADES. These transactions involve: (1) a purchase of securities for current settlement; (2) a delayed settlement sale of these securities or the possession of a long standby; and, (3) a financing of a long position by a sale under an agreement to repurchase on or before the future delivery date.

INTERMEDIATION. The phenomenon that occurs when rates paid by certain financial intermediaries can compete successfully with the rates being paid by others (e.g., the U.S. Government on its Treasury Bills). This causes an expansion in the amount of deposits held by the intermediaries which are able to pay higher rates. See Disintermediation.

INVENTORY. The total issues, long and short, held by a dealer comprise that dealer's inventory.

INVERTED MARKET. A futures market in which the nearer months are selling at prices higher than the more distant months; hence, a market displaying inverse carrying charges. This is characteristic of markets in which supplies are currently in shortage.

INVESTMENT TRUSTS. Similar to a mutual fund but has a fixed sum of money as a corpus when formed. Also called a Closed-End Fund.

ISSUER. One who issues securities, usually a mortgage banker, who pools mortgages to back GNMA pass-through securities. See Originator.

LEGAL ELIGIBILITY. Investments that life insurance companies, mutual savings banks, or other regulated investors may make under a state charter, law, or regulation.

LIQUIDATION. Making a transaction that offsets or closes out a position; closing out a defaulted transaction.

LONG.

(1) Descriptive of one who owns securities or commodities.

(2) Descriptive of one who has bought a forward or futures contract and has not yet offset that position by making a counterbalancing transaction.

LONG THE BASIS. A person or firm that has bought immediate and hedged with a sale of futures is said to be long the basis.

MAINTENANCE MARGIN. The amount of equity required to be maintained in a margin account in accordance with exchange regulations or house rules. If a customer's equity drops below the required level, the broker issues a margin call to the customer for a payment sufficient to restore the equity. Also called Variation Margin.

MAKER. See Writer.

MARGIN. A deposit of cash or collateral by a client with a broker (or by a broker with a clearing house) which provides a measure of protection to the broker (or clearing house) in the event of adverse price movement on an open position, coupled with a default by the client (or broker). Margin in commodities is not a payment for equity or down payment on the commodity itself but rather is in the nature of a performance bond or security deposit. The difference is significant because (1) both buyers and sellers post margin in commodities; (2) the remainder of the position is not being borrowed from one's broker and does not require interest payments; and, (3) as price moves against one's position, the account is debited and the protection represented by the initial margin may fall below the prescribed maintenance level, in which case the trader will be required to post additional margin. See Initial Margin, Maintenance Margin, Original Margin, and Variation Margin.

MARGIN CALL.

(1) A call from a brokerage firm to a customer to bring margin deposits up to minimum levels required by exchange regulations.

(2) A request by the clearing house to a clearing member to bring clearing margins back to minimum levels required by the clearing house rules.

MARKET ORDER. An order to buy or to sell a stated amount of a security at the most advantageous price obtainable after the order is entered.

MARKET PRICE. In the case of a security, market price is usually considered the last reported price at which the security sold.

MARKETABILITY. The capacity of the market in a particular security to absorb a reasonable amount of buying and of selling at reasonable price changes. The degree of investment interest underlying a security. Marketability largely determines the value of a security in the marketplace. Liquidity is considered an attribute of marketability.

MARK TO MARKET. A procedure whereby a brokerage concern has the right to demand that the price of a past due or open contract be adjusted to current market values by the advancement of additional funds. The making of a mark to market payment restores original margin.

MARKUP. The difference between what a dealer has paid for a security and the price at which the security is offered to another person. Also called Spread.

MATCHED REPURCHASE AGREEMENT (MATCHED REPO). Matched repurchase agreements include transactions in which a dealer acquires a security on a reverse repurchase agreement or a collateral loan, only when the dealer has outstanding commitments both to repurchase and to resell the security on the same date. If the reverse repurchase agreement is made first in anticipation of a subsequent matching agreement, the transaction is not a matched agreement until the security is sold under a repurchase agreement. Matched agreements also include transactions in which a dealer is in any way subject to a contingent liability, as well as those where the dealer is acting as an agent in a transaction that involves the temporary exchange of cash for securities between two or more other parties but remains contingently liable for any losses incurred because of the failure of any of the other parties to fulfill their part of the agreement.

MATURITY. The terminating or due date of a note, time draft, acceptance, bill of exchange, mortgage-backed security, or bond. The date a time instrument of indebtedness becomes due and payable.

MONEY MARKET. The market, for short-term, high-grade financial instruments, such as bankers acceptances, certificates of deposit, and commercial paper.

MORTGAGE-BACKED SECURITIES DEALERS ASSOCIATION. A voluntary association of dealers in Ginnne Mae mortgage-backed securities. The association changed its name from the GNMA Mortgage-Backed Securities Dealers Association.

MORTGAGE BANKER. A company that specializes in originating mortgage loans for sale to permanent investors. It frequently continues to service the loans it has sold. As the local representative of regional or national institutional lenders, it acts as a correspondent between lenders and borrowers.

MORTGAGE BANKERS ASSOCIATION OF AMERICA (MBA). An association of mortgage bankers. The association serves as the trade association for the mortgage banking industry.

MORTGAGE BANKING. The packaging of mortgage loans secured by real property to be pooled to back issues of Ginnie Mae securities or sold to a permanent investor, with servicing retained for the life of the loan. The origination, sale, and servicing of mortgage loans by a firm or an individual. The investor-correspondent system is the foundation of the mortgage banking industry.

MUNICIPAL SECURITIES RULEMAKING BOARD (MSRB). An agency established by Congress to establish rules for brokers and dealers affecting transactions in obligations of, or guaranteed by, state or local governments or any political subdivision, agency, or instrumentality thereof.

MUTUAL FUNDS. Investment portfolios managed by brokerage firms or investment companies for investors. Open-end mutual funds permit the public to buy or to sell units of the fund at specified times by contributing or by withdrawing equity. Closed-end mutual funds are also called Investment Trusts.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. (NASD). An association of brokers/dealers who do business in the over-the-counter market. The association supervises and regulates the trading conduct of its members. The NASD was created under Section 15A of the Securities Exchange Act of 1934.

NEGATIVE ARBITRAGE. See Arbitrage.

NEGOTIABLE SECURITY. Under the UCC (see Uniform Commercial Code), an instrument that meets certain legal requirements and can be transferred by endorsement or delivery.

NET CAPITAL. Net worth of a brokerage concern, less certain items such as exchange memberships, carrying value of securities which are not readily marketable, "haircuts" on marketable securities in proprietary accounts, furniture and equipment, etc.

NET LONG. The net long remaining after substracting short contracts.

NET POSITION. The difference between the open long contracts and open short contracts held in any one commodity. Trades which have been offset are removed from the net position.

NET SHORT. The long position subtracted from the short position. The net of these is the net short position.

NET YIELD. The part of gross yield that remains after the deduction of all costs, such as mortgage servicing expenses and guaranty fees. See also Yield.

ODD LOT. A quantity of securities which is less than the trading unit. For instance, an odd lot for Ginnie Maes is a quantity less than one million dollars.

OFFER. The lowest price at which a seller is willing to sell a security at a particular time; opposite of Bid.

OFFSET. The liquidation of a purchase of futures through sale of an equal number of contracts of the same delivery month or the covering of a short sale of futures through the purchase of an equal number of contracts of the same delivery month. Either action cancels the obligation to make or take delivery of the commodity.

OPEN INTEREST. The total number of future contracts on a given commodity which have not yet been liquidated by offset nor fulfilled by delivery; the total number of open transactions. Each open transaction has a buyer and a seller, but for calculation of open interest, only one side of the contract is counted.

OPEN POSITION. Forward contracts are included in an open position if they have not been offset or fulfilled by delivery. Futures contracts are "open" if they have not been liquidated by offset or fulfilled by delivery. The open position includes open long and short contracts.

OPTION. An option is a contract which gives the purchaser the right to buy or to sell in accordance with the terms of the contract, rather than the obligation to do so. Ginnie Mae securities are sometimes traded for optional delivery. See also Standby Commitment, Optional Commitment, Put and Call.

OPTIONAL COMMITMENT. An option to receive securities, exercisable at a future date. The buyer of the optional commitment has the option to receive the securities. A long optional commitment is an option to purchase securities. A short optional commitment is a commitment to sell. See also Option and Call.

OPTIONAL COMMITMENT FEE. Amount paid for the purchase of an optional commitment. Also called a Premium.

ORIGINAL MARGIN. Term applied to the initial deposit of margin money required of clearing member firms by clearing house rules.

ORIGINATION. The process whereby a Ginnie Mae certificate, backed by approved mortgages in a pool, is the issued. See Issuer.

ORIGINATOR. One whose function is to originate or issue mortgage-backed securities. Builders, brokers, and others are solicited to obtain applications for mortgage loans. The individual mortgage company which performs this function is also designated as the originator or issuer. See Issuer.

OUT OF THE MONEY. An option that will not be exercised under current market conditions (e.g., the option to purchase is at $100, while the actual market is below $100).

OUTPUT. The volume of mortgage securities that a mortgage company can be expected to issue in a month. Also called Production or Origination.

OVERTRADING. See Adjusted Trading and Fee Trading.

P&I. Abbreviation for "principal and interest." This is customarily used to describe the regular monthly checks paid to the registered owner of Ginnie Mae securities by the issuer. Payment of P&I is scheduled to arrive by the 15th of each month and contains the interest, regular principal payments, and prepayments made on a pro rata basis by the entire pool for the previous calendar month.

PAIR OFF. The matching or netting of contra transactions between two parties when delivery is due. Only the unmatched balance is delivered with a check for the difference between the purchase and sale prices of all transactions being received or delivered. This reduces the number of physical deliveries and redeliveries which otherwise would be required.

PAPERS. Term sometimes given to put or call options.

PAR. 100% of issue price.

PAR CAP. A provision in the contract of sale for Ginnie Mae securities which restricts delivery only to pools which bear an interest rate sufficiently high so that the securities would trade at or below par when computed on the agreed-to yield.

PARTICIPATION CERTIFICATE. A type of mortgage-backed security which represents an undivided interest in certain real estate loans.

PASS-THROUGH. As used in the Ginnie Mae securities market, signifies that the interest and principal payments due and/or paid on the underlying mortgages are passed through to the holders of the securities on a pro rata basis.

PAYING AGENT. An agent, usually a commercial bank, engaged by an issuer to effect dividend or interest payments periodically.

PERMANENT INVESTOR. One who provides permanent mortgage financing.

POINT. An amount equal to 1% of the principal amount of an investment or note. Loan discount points are a one-time charge assessed at closing by the lender to increase the yield on the mortgage loan to a competitive position.

POOL. A collection of mortgages which are packaged and sold as a security. Security holders of Ginnie Mae pass-through securities own a pro rata share of the outstanding balance of all mortgages in the same pool. Pools must be mortgages of the same kind (single family, mobile home, or projects), carrying the same rate of interest, and must all be of the same duration (e.g., 30 years). All mortgages within a single pool are serviced by the same issuer and are usually from the same geographic area.

POSITION. An interest in the market, either long or short. Securities purchased and held are a long position. Securities sold short and not yet covered are a short position. Forward or futures contracts purchased are called a long position. Forward or futures contracts sold and not yet liquidated are called a short position. See also Open Position and Net Position.

POSITION LIMIT. The maximum number of speculative futures contracts in one commodity that a person (or group of persons under certain circumstances) can hold as determined by the Commodity Futures Trading Commission and/or the exchange upon which the contract is traded.

PREMIUM. The amount by which a security may sell above its face value. In the case of a new issue, the amount that the market price rises over the original selling price. Also refers to a charge sometimes made when a security is borrowed to make delivery on a short sale. May also refer to the redemption price of a security if that price is higher than the security's face value.

PRICE LIMITS. The maximum price advance or decline from the previous day's settlement price permitted for a contract in one trading session by the regulations of a futures exchange.

PRIMARY DEALER. A dealer which reports its activities and resource commitments to the Federal Reserve Bank of New York.

PRIMARY MARKET. Offerings in newly issued securities. See also Secondary Market.

PRINCIPAL TRANSACTION. A securities transfer wherein one or both of the parties acts as principal dealing for his/her own account.

PRODUCTION. The aggregate of mortgages assembled by a mortgage company. For example, if a mortgage company generates $1 million per day of new mortgages, it is said to be a $5 million a week producer.

PROXY. Whenever one person acts on behalf of another, the first person is acting as proxy for the second. Similarly, one instrument can be viewed as a proxy for another when the primary instrument is unavailable or too costly. Warehouse receipts or depository receipts may be used as proxies for commodities or securities.

PUBLIC SECURITIES ASSOCIATION (PSA). An association of dealers in government securities. The association serves as the trade association for brokers and dealers in exempt securities.

PUT. An option contract which entitles the holder to sell (put), entirely at the holder's option, a specified quantity of a security at a specified price any time until the stated expiration date of the contract. Such an option is bought with the expectation of a price decline below the contract price. If the price decline occurs, the purchaser will exercise the option. If the decline does not occur, the purchaser will let the option expire and will lose only the cost of the option.

PUTS AND CALLS. Options to sell (put) or buy (call) securities within a specified period of time at specified prices.

PYRAMIDING. Successive borrowing on securities to finance the purchase of additional securities.

QUALITY. A security is said to be of high quality if the return on principal and the payment of interest are well secured or guaranteed.

QUOTATION. The bid to buy and the offer to sell a security in a given market at a given time. Often shortened to "quote." See also Bid and Asked.

RATE OF INTEREST. Annual interest rate of a pool; the coupon rate. Not necessarily the same as yield.

REAL ESTATE SYNDICATE. A group of investors who pool funds for investment in real property.

REGISTERED. Issued in the name of the owner or the owner's nominee. Also, opposite of Exempt. A registered security may not be issued without the filing of a registration statement with the SEC.

REGULATION Q. The name for the Federal Reserve Board's regulation governing the maximum interest rates that may be paid on certificates of deposit.

REGULATION T. The name for the Federal Reserve Board's regulation governing the amount of credit that brokers and dealers may extend to customers who buy securities.

REGULATION U. The name for the Federal Reserve Board's regulation governing the amount of credit that banks may extend to customers who borrow money to buy securities on margin.

REPURCHASE AGREEMENT (REPO). A financing transaction whereby one party invests or lends funds to another party and receives securities as collateral.

REVERSE REPURCHASE AGREEMENT (REVERSE REPO). A financing transaction whereby one party borrows funds and offers its securities as collateral.

RICH. Wall Street vernacular for the relative value of one security to another in terms of its historical price relationship. If a security is rich, it is overpriced relative to another security. See also Cheap.

ROLLING FORWARD. A type of transaction, including a repurchase agreement, in which an investor receives a positive interest carry on an actual position but has sold the security as a forward.

SAFETY. An attribute of an investment. Safety is often associated with securities that are insured or guaranteed.

SECONDARY MARKET. The resale market for securities. See also Primary Market.

SECURITIES AND EXCHANGE COMMISSION (SEC). An agency established by Congress to regulate the corporate securities market. Brokers and dealers in securities are required to register with the SEC.

SECURITIES INDUSTRY ASSOCIATION (SIA). A trade association of securities dealers. The PSA is affiliated with the SIA.

SECURITY. A common or preferred stock, a bond, a U.S. Government or agency issue, or a state or municipal obligation. See also Negotiable Security.

SELF-REGULATORY ORGANIZATION (SRO). Any organization which develops regulations for its members and enforces the regulations. Typically, enforcement is obtained by expulsion of members who do not follow the regulations.

SELLER-SERVICER. An approved corporation that sells mortgages to, and services mortgages for, FNMA, GNMA, and/or FHLMC.

SELLER'S OPTION. The right of a seller to select, within the limits prescribed by a contract, the quality of the commodity delivered and the time and the place of delivery.

SELLING HEDGE. Selling futures contracts to protect against possible decreased prices of commodities. Also called Short Hedge. See Hedge.

SELL OUT. Action taken by a broker or a dealer to liquidate an account or a transaction for failure to maintain proper margin or to make timely payment.

SERVICING. The duties of the mortgage banker as a loan correspondent, per specifications in the servicing agreement for which a fee is received. The collection for an investor of payments, interest, principal, and trust items, such as hazard insurance and taxes, on a note by the borrower in accordance with the terms of the note. Servicing also consists of operational procedures covering accounting, bookkeeping, insurance, tax records, loan payment follow-up, delinquency loan follow-up, and loan analysis.

SERVICING AGREEMENT. A written agreement between an investor and a mortgage loan correspondent stipulating the rights and obligations of each party.

SETTLEMENT DATE. The date agreed upon by parties to a security transaction for the actual payment of funds and the transfer of the security.

SETTLEMENT PRICE. The price at which a security or a commodity is to be settled. Used primarily in connection with clearing house operations. In commodity trading, the settlement price is based on the closing price or the range of closing prices on the day on which the notice of intention to deliver is filed.

SHORT. Opposite of Long.

(1) Descriptive of one who owns a security or commodity, as after a short sale, before it has been covered.

(2) Descriptive of one who has sold a forward or futures contract and has not yet offset that position.

SHORT COVERING. The purchase of securities so that securities previously sold to make delivery on a short sale may be returned. To close a short position.

SHORT HEDGE. See Selling Hedge.

SHORT SALE.

(1) A sale of securities by a customer which requires the borrowing of equivalent securities to make delivery to the purchaser.

(2) A sale of a forward or futures contract with the intention of buying to offset it at a later date.

SHORT THE BASIS. Persons or firms which have sold a spot commodity which is not then owned but which has been hedged with a purchase of futures.

SPECULATE. Buy or sell commodities, futures, or forward contracts without hedging to reduce the risk. To trade (e.g., Ginnie Maes) with the hope of quick profit by market movement as opposed to investment income. See Speculator.

SPECULATOR. One who does not hedge but who trades in commodities, futures, or forward contracts with the objective of achieving profit through the successful anticipation of price movements. In a legal sense, a speculator is any commodity futures trader not defined as a bona fide hedger by the Commodity Futures Trading Commission, if such a definition applies to a futures contract.

SPOT. Refers to the characteristic of being available for immediate (or nearly immediate) delivery. An outgrowth of the phrase "on the spot." It usually refers to a cash market price for delivery or, conversely and depending upon the noun it modifies, the stocks themselves that are available for delivery if an acceptable price is quoted. Thus, cash market transactions are usually grouped into two kinds - spot and forward contracts. However, "spot" is also sometimes used in reference to the futures contract of the current month, in which case trading is still "futures" trading but delivery is possible at any time.

SPOT COMMODITY. See Actuals.

SPOT PRICE. The price at which a physical commodity is selling at a given time and place. Same as Cash Price.

SPREAD.

(1) The difference (usually expressed in 32nds of a point) between the bid price and the offer price quoted by a dealer in a security.

(2) The difference in price or yield between two different securities (e.g., there may be a spread of 50 basis points in yield between securities and 30-year Treasuries).

(3) The difference in price between the futures of a commodity for one month and the futures of the same commodity for another month.

(4) A different meaning is used in hedging transactions. A spread is the simultaneous purchase and sale of the same securities or commodities for delivery on different dates at different prices, or the purchase of one commodity and the sale of a different commodity with the same delivery date, or the purchase and the sale of the same commodity in two different markets. The spread takes advantage of and profits from differences in prices and changes in price relationships. See also Switch and Arbitrage.

SPREADING. The purchase of one futures contract and the sale of another, in the expectation that the price relationships between the two will change so that a subsequent offsetting sale and purchase will yield a net profit. Examples include the purchase of one delivery month and the sale of another in the same commodity on the same exchange, or the purchase and the sale of the same delivery month in the same commodity on different exchanges, or the purchase of one commodity and the sale of another (wheat vs. corn or Ginnie Maes vs. long-term U.S. Treasury bonds), or the purchase of one commodity and the sale of the products of that commodity (soybean vs. soybean oil and soybean meal). When the terms of the contract and all other relevant factors indicate that the price relationships between the contracts should be constant, but price discrepancies develop due to temporary supply-demand imbalances, spreading operations to take advantage of such discrepancies are sometimes called arbitrage. However, true spreading involves the making of judgements about price relationships which are subject to gradual change due to economic factors which vary over a period of time and is, therefore, a form of speculation.

STANDBY COMMITMENT. A commitment to purchase a loan or loans with specified terms, both parties understanding that delivery is not likely unless circumstances warrant. The commitment is issued for a fee, with willingness to fund in the event that a permanent loan is not obtained. Such commitments are typically used to enable the borrower to obtain construction financing at a lower cost on the assumption that permanent financing of the project will be available on more favorable terms when the improvements are completed and the project is generating income.

STANDBY FEE. The fee charged by an investor for a standby commitment. The fee is earned upon issuance and acceptance of the commitment.

STREET NAME. A registered security which has been endorsed in blank or endorsed in favor of a recognized dealer is said to be in street name.

STRIKE PRICE. The price at which securities can be purchased or sold upon exercise of a standby or an optional commitment. Also called Exercise Price.

STRIPS or STRIP TREASURIES. See Zero Coupon Treasury Bonds.

STUFFED PIG. A transaction initiated by a dealer for a client without authorization from the client. See also Wooden Ticket.

SWAP. The simultaneous purchase and sale of two different securities or two different issues of the same security to increase relative marketability, profit, yield, or income.

SWITCH. Liquidation of a position in one delivery month of a commodity and simultaneous initiation of a similar position in another delivery month of the same commodity. When used by hedgers, this tactic is referred to as rolling forward the hedge.

TAKE OUT BID. A GNMA dealer agrees to purchase Ginnie Mae securities at a specific price from a mortgage banker, subject to a successful bid for mortgages sold at auction. This take out or backup bid allows mortgage bankers to bid on the purchase of mortgages, obtained from GNMA, to their servicing portfolios. This two-party agreement helps GNMA to implement its management and its liquidation functions. In net effect, the mortgage banker is purchasing the mortgage collateral and is financially backed by the Ginnie Mae dealer.

TERM. The period of time between the commencement date and the termination date of a note, mortgage, legal document, or other contract.

"TIGRS". See Zero Coupon Treasury Bonds.

TO BE ANNOUNCED (TBA). Future Ginnie Mae pools "to be announced," which are bought and sold for future settlement. "To be announced" refers to interest rates and due dates, which are determined when available. Trading in these securities is often done on a yield basis.

TRADE. Either a purchase or a sale of a security.

TRADING. The act of carrying out purchasing and/or selling in a security or a securities market.

TRADING INCOME. Income derived from the trading of a portfolio of securities.

TRADING PROFITS or LOSSES. Profits or losses resulting from the trading of a portfolio of securities.

TRANSFER. When a registered instrument is acquired, it is sent to the transfer agent for transfer. The transfer agent records that this certificate is no longer owned by the previous holder but is now owned in the name of the individual who has acquired it.

TRANSFER AGENT. Transfer agents keep records of the names of each registered share/owner, the address, the number of certificates owned, and they see that certificates presented to their office for transfer are properly canceled and that new certificates are issued in the name of the transferee.

TREASURY BILL (T-BILL). A direct obligation of the U.S. Government issued at regular auctions on a discount basis for periods of 13 weeks or up to 1 year.

UNDERWRITING. Securities dealers use this term to designate the issue of origination of new securities. Mortgage bankers generally use the term to indicate the analysis of risk and the matching of risk to an appropriate rate and term.

UNIFORM COMMERCIAL CODE (UCC). A comprehensive law regulating commercial transactions. It has been adopted, with modification, by most states.

UP-FRONT FEE. See Fee.

VARIATION MARGIN. Used in commodity operations. Refers to last day point fluctuation (difference between prior day's settling price and last day's settling price) on net position long and short. Also called Maintenance Margin.

WAREHOUSING. The borrowing of funds by a mortgage banker on a short-term basis at a commercial bank, using permanent mortgage loans as collateral. This form of interim financing is used until the mortgages are sold to a permanent investor. It is a form of "line of credit" financing.

WOODEN TICKETS. A transaction initiated by a dealer for a client without authorization. See Stuffed Pig.

WRITER. The grantor of an option contract. Also called the Maker.

YIELD. The yield on a bond is the annual percentage of return that it pays. In real estate, the term refers to the effective annual amount of income which is being accrued on an investment, expressed as a percentage of the price originally paid. See also Net Yield.

YIELD ON AVERAGE LIFE. Ginnie Mae yields are quoted from tables which calculate the yield on a single loan prepaid at the end of 12 years. It is assumed that such a yield calculation is fairly representative of a pool of loans wherein the average loan life is thought to be 12 years. This is not a guarantee of investment results, but an accepted practice for trading Ginnie Maes and mortgages in secondary markets. The "12-year average life" convention is based largely upon FHA statistics.

YIELD MAINTENANCE CONTRACT. Concurrent commitment to purchase a security via a cash forward agreement and to sell the same security on the same settlement date via a standby commitment. Also refers to a forward contract written with terms which maintain the yield at a fixed rate until the delivery date.

YIELD TO MATURITY. A percentage returned each year to the lender on actual funds borrowed, considering that the loan will be paid in full at maturity.

ZERO COUPON TREASURY BONDS. (TIGR'S, ETR'S, CAT'S, Stripped Treasuries). This security results from the separation of the principal and interest portion of a U.S. Government obligation. The holder of a stripped security has the right to receive either the principal balance upon maturity or the periodic interest payments to be made by the issuer. These instruments are sold at a discount from the fact accounts. Since the underlying obligation is that of the U.S. Government, zero coupon treasury bonds are legal investments for Federal credit unions.

## SAMPLE BAILMENT AGREEMENT OF SECURITIES

This Agreement is made between ABC Federal Credit Union, herein referred to as the Credit Union and ZYZ Bank, Anytown, USA, hereafter referred to as Custodian.

WHEREAS the Credit Union will desire, from time to time, the Custodian to hold certain securities for the Credit Union, it is hereby agreed between the Parties that:

### SECTION I

The Custodian agrees to act as bailee and custodian of any securities that the Credit Union might deliver to the bailee for safekeeping. The Credit Union may demand redelivery of the property hereby bailed at any time upon demand.

The Custodian shall also provide to the Credit Union a custodial or safekeeping receipt identifying the specific security or securities delivered by any party for the account of the Credit Union within two (2) business days from the time of receipt of such security or securities.

### SECTION II

The Custodian agrees to be the bailee of such securities as described above for the consideration of one dollar and other mutually agreeable considerations between the Parties.

### SECTION III

Delivery of securities shall be made to the bailee at its corporate banking offices and whatever branch agreeable between the Parties.

### SECTION IV

The bailee agrees to keep and maintain the securities with proper care so that they will be secure and assumes liability for the safekeeping of such securities in accordance with safe banking standards.

### SECTION V

The securities are and will remain, and at all times, shall be deemed to be the sole and exclusive property of the Credit Union and bailee has no right to property therein. The securities shall not be transferred or delivered to any other person or corporation without prior written consent or instruction of the Credit Union and neither the disagreement nor the bailment hereby established may be assigned by the bailee either by his own act or by operation of law.

## SECTION VI

The term of this Bailment Agreement shall commence on the day this Agreement is executed and terminated upon written notice of either Party delivered to the addresses set forth in the Preamble.

EXAMINER'S NOTE:

An attorney's opinion should be obtained before using this form to ensure that the form is acceptable within the state the credit union operates.

## 10. Share Structure

Share accounts and share certificate accounts are the primary source from which credit unions obtain funds. The proper share mix or share structure of a credit union must take into consideration the cost of funds, the matching of funds with corresponding assets and the needs of members. Giving due consideration to these, the entire funds management program must be viewed in light of constraints placed upon it by the financial marketplace as a whole. The share program should incorporate and reinforce the asset liability management policies of the credit union. The credit union should monitor the program and make appropriate changes when needed. Although the examiner's analysis will encompass the technical exceptions that might be found, the most critical part of the analysis is the development of the interrelationship between the flow of funds and the use of these funds for producing income and maintaining liquidity.

Objectives in reviewing share structure are to determine that:

(1) Share policies are realistic in terms of the financial market in which the credit union must operate;

(2) The members' needs are met;

(3) The share program provides for adequate earnings and funds flow;

(4) Adequate controls are maintained over the operational aspects of the share program;

(5) The share program meets all legal requirements; and

(6) Corrective action is taken when deficiencies are noted.

The extent of the examiner's analysis of share structure will depend upon the complexity of a credit union's share make up. The review of this area should be recorded on NCUA 2055, Examination Checklist.

### 10.1 Share Management

In reviewing the share program, the examiner should determine that the officials are aware of the interrelationships between the costs and types of share and share certificate accounts offered and the movement of funds in and out of the credit union. The officials should attempt to match shares to assets with the same characteristics, i.e., maturities. The share policy should evidence a management concern for minimizing the problems typically associated with "borrowing short and lending long." If the credit union has most of its assets in long-term loans, then the officials should strive to offer share and share certificate accounts with expanded maturity and restricted withdrawal features. On the other hand, if the credit union has most of its assets in short-term loans then the officials could probably just offer regular type share accounts and short-term share certificates. As internal and external changes impact upon the funds management program, changes in share structure become necessary. Management must balance the goals and objectives of the credit union with the makeup of the share mix. Typical management considerations are:

(1) Does the credit union have a planned program for its share structure?

(2) What are the members' needs?

(3) Are share accounts matched with corresponding asset accounts?

(4) Is the cost of funds appropriate for the sound operation of the credit union?

(5) Does the share structure provide for adequate cash flow?

(6) Are shares increasing, decreasing or constant?

(7) Do large share accounts show unusual activity?

(8) Are share policies reviewed periodically and changed when warranted?

### 10.2 Cost of Shares

The effective cost of share and share certificate accounts is an important consideration. The examiner can determine the amount of funds outstanding at each rate and then compute a weighted average to determine the effective cost to the credit union.

Regular share accounts, which typically have a constant inflow and outflow of funds, may have an effective cost to the credit union that is less than the nominally stated dividend. The reason for this is that shares upon which dividends are to be paid are not constant, even though the amount of shares outstanding may be the same at the beginning and the end of the dividend period. If the credit union had $100,000 in shares outstanding for a full year and was paying a 6 percent dividend with no activity in the account, the dividend cost would be $6,000. More typically, the dividend would be somewhat less than $6,000, thus reflecting the activity in the share accounts. The dividend period and method of compounding will of course have an effect on the amount of dividend actually paid.

A relatively simple way of determining the effective cost on these types of active share accounts is to take the actual amount of dividends paid in previous periods and divide this by the amount of shares outstanding for the same period. An average of a year's amount of dividends should provide a reasonable estimate of the cost for these types of shares. The examiner should be careful when developing this information because external influences on shares may distort the reliability of this method as a predictor of costs.

Example:

The credit union's share structure as of October 31, 19XX:

| | Type of Account | AmountNominal Rate |
|---|---|---|
| Regular share | $135,000 | 6% |
| Share certificate | 40,000 | 7% |
| Share certificate | 30,000 | 8% |

The end-of-month balances for the third quarter for regular shares:

| | |
|---|---|
| July 19XX | $100,000 |
| August 19XX | 90,000 |
| September 19XX | 130,000 |
| | $320,000 |

The actual amount of quarterly dividend paid on these shares was $1,400.

Question: What is the effective cost for the total share structure for October 31, 19XX?

Solution:

(1) Determine average regular shares outstanding during dividend period.
$320,000/3 = $106,667 per month

(2) Divide actual dividend paid by average shares.
$1,400/$106,667 = .013125

(3) Multiply times number of dividend periods in year to annualize.
4 x .013125 = 5.25%

(4) The approximate cost for regular shares is 5.25%.

(5) Compute the weighted average cost of the entire share structure as of October 31, 19xx.

| Type of Account | Effective Rate | Amount | |
|---|---|---|---|
| Regular shares | 5.25% x | $135,000 = | $ 7,088 |
| Share certificate | 7.00% x | 40,000 = | 2,800 |
| Share certificate | 8.00% x | 30,000 = | 2,400 |
| | | $205,000 | $12,288 |

The weighted average cost is $12,288/$205,000 = 5.99%.

## 10.3 Share Account Types

A Federal credit union is unrestricted in the types of share accounts it can offer to its membership. Generally, share types fall into the broad categories of Regular Shares, Share Draft, Share Certificate, Money Market and Retirement Plan accounts. Other less commonly used accounts include Escrow, Nonmember and Public Unit accounts.

### 10.3-1 Regular Type Shares

Every Federal credit union must make available to its members a share account which does not require the holder to maintain a mininum balance greater than the par value of a share; this will provide for continued membership in the credit union. However, Federal credit unions are free to fashion variations of the the traditional regular share account.

## 10.3-2 Share Drafts

By traditional definition, a share draft account is an account from which the holder is authorized to withdraw shares by means of a negotiable or transferable instrument or other order. Share draft accounts may differ from regular share accounts. The board of directors should determine, prior to implementing a share draft program, that the members' use of share drafts is economically and operationally feasible. The program should be supported by written operational and program specifications that are available at the credit union's principal office.

### 10.3-2.1 Examination Procedures

Examiners should review share draft programs during each examination to determine the extent of control over share draft processing, balancing and posting, including prompt (daily) review and processing of overdrafts, related loan advances and processing exceptions. The extent of the examiner's analysis of share drafts will be expanded when material problems are encountered. The examiner will record the extent of the share draft analysis on NCUA 2055, Examination Checklist.

Share draft operational problems such as out-of-balance Individual Share Draft ledgers, failure to promptly post share drafts, out-of-balance bank settlement accounts or lack of proper control over overdraft activity and exception processing are material problems which affect the overall ability of a credit union's share draft program to function properly. Because share draft programs involve third parties, the reputation of the credit union and its members may be easily damaged by the failure of the credit union to properly maintain internal operations. Delays in processing drafts received for payment could also cause the credit union material losses.

### 10.3-2.2 Operational Flow

Share drafts may be used as a part of the remote funds withdrawal procedures available to credit union members. Under this program the following actions take place:

(1) Members establish a share draft account by signing a share draft agreement.

(2) The credit union provides members with a book or books of share drafts.

(3) Members write drafts and present them to third parties for purchase of goods or services, or draw drafts for cash.

(4) Payees ordinarily present the drafts received to their own banks (drafts are deposited with other receipts).

(5) The payee's bank forwards the drafts through bank clearing channels for presentation to the credit union's payable-through bank.

(6) The payable-through bank receives the drafts and makes provisional payment subject to payment or dishonor by the credit union.

(7) Upon receipt of the drafts, the payable-through bank presents the information on the drafts to the credit union. Normally the information on the share drafts is converted to an electronic medium at this point (magnetic tape) and is transmitted to the credit union for payment or dishonor (the information may also be transmitted directly to the credit union's EDP supplier).

(8) The credit union then approves payment and posts the share withdrawals to the members' accounts.

(9) Members receive a periodic statement of account which identifies drafts paid and payments received during the period.

### 10.3-2.3 Sound Operation

It is the responsibility of the board of directors to ensure that sound operational and control procedures are implemented to safeguard the integrity of a share draft program. A credit union should obtain a written legal opinion that the program not only conforms with Federal law and regulations, but also any state law requirements or other requirements, such as clearing house rules. A credit union may use its own routing and transit number (payable-at method) or the routing and transit number of the payable-through bank (payable-through method). The board of directors should thoroughly investigate the cost and conveniences of the two methods before one is selected. Any other acceptable method may be used.

Other requirements of a share draft program may include:

(1) A complete and detailed share draft agreement outlining the credit union's and the member's responsibilities;

(2) A written document that sets forth the operational and program specifications of the share draft program to be implemented;

(3) A provision for retaining copies of paid share drafts on file for 5 years or as required by state law, whichever is greater. Credit unions may use any type of photo reproduction to meet this requirement; and

(4) Provisions for stop payment on share drafts for which the member does not wish to pay.

### 10.3-2.4 Overdrafts

At the time a credit union receives a share draft which overdraws a share draft account, it has several options available:

(1) The draft may be returned as not paid for lack of sufficient funds. If this action is taken, it must be done within the time limits permitted for returning items through the bank clearing system to the payee.

(2) The draft may be accepted pending receipt of payment from the member to cover the overdraft. Normally, the credit union will advise the member by telephone of the overdraft and will request that the member deposit sufficient funds to cover the draft prior to expiration of the time limits imposed for returning the draft. This procedure will usually involve only small overdrafts. The credit union is required to establish sufficient authorization procedures to provide internal controls for this activity.

(3) The draft may be accepted and an overdraft created, and then cleared by a transfer from another share account from which the member is authorized to withdraw (both accounts would be transaction accounts for the purposes of Monetary Control Act Reserves).

(4) The draft may be accepted and the overdraft cleared by an advance from a line of credit, special loan plan or other arrangement established with the member. The line of credit agreement should be separate from the share draft agreement and must comply with any provisions for lines of credit in the Rules and Regulations. Authorization may be included in the Share Draft Agreement for the credit union to transfer the amount of loan advance to the share draft account, provided that wording such as the following is used:

> "In the event that any of the undersigned writes a share draft which would result in this share draft account being overdrawn, and if at that time any of the undersigned is eligible to receive advances from this credit union under the loan account referred to above, that share draft shall be deemed to be a request to the credit union for an advance under such loan account in multiples of $__________ sufficient to permit the credit union to honor such draft and credit the advance to the share draft account."

Under this procedure, advances would be made by a designated person working from a listing of drafts overdrawing share draft accounts. The listing becomes a permanent part of the credit union's records. Additional conditions necessary for using this procedure involve:

(1) persons signing the agreement must be members to ensure that all persons who are parties to the agreement are eligible for a loan, and

(2) notification of each overdraft should be forwarded to the members at the time it occurs. If, however, the credit union issues monthly statements, it may not be necessary to send overdraft notices if overdrafts are clearly indicated on the monthly statements. If an overdraft notice is issued, it should identify the draft overdrawing the share draft account by serial number, the date received and the amount. The method and timing of the notice is at the discretion of the board, but it should not be less frequently than monthly.

All overdrafts occurring on the share draft account are reflected on the statement of account as a debit balance. This procedure should be followed regardless of whether or not the overdraft is to be cleared by an advance from a loan account or from another share account. An exception to this requirement is provided for EDP systems which have the capability of preparing a list of drafts which will overdraw a share draft account if they are posted. In these systems the credit union officials are able to take action to prevent the occurrence of an overdraft by posting an advance from a line of credit to the share draft account or making a transfer from another share account prior to posting the draft which would have overdrawn the account. If a credit union has the capability, this method may be used in lieu of posting the draft and creating a debit balance before posting the proceeds of a loan or other funds to the account. The member would then receive notification of the overdraft. The draft which would have created the overdraft situation is posted to the share draft account on the same day as the line of credit advance or share transfer.

### 10.3-2.5 Verification

Since the credit union officials do not actually review the share draft received for payment to determine if the member signed the draft presented, the procedures to verify the authenticity of the transaction depend upon the member's review of the periodic statement for unauthorized drafts. If an overdraft is created as a result of unauthorized drafts, the member, upon notification of an overdraft, has the opportunity to notify the credit union.

When a credit union receives notice of an unauthorized draft, the original draft or a copy of the original draft should be retrieved for comparison against the signature card on file at the credit union's office. The board of directors should determine that there is adequate insurance coverage for forged drafts.

### 10.3-2.6 Settlement Accounts

In order to make settlement for drafts which are provisionally paid by a payable-through bank, credit unions normally maintain a deposit account in the payable-through bank. Other alternatives for settlement include use of an investment account, such as an account with a common trust, a savings and loan association or corporate central credit union through which funds are transferred to the payable-through bank via preauthorized agreements. The payable-through bank writes drafts against these accounts. The bank may also accept drafts in an account receivable clearing status and at the end of each day draw a draft against the credit union's checking account in a bank where the credit union does business.

### 10.3-2.7 Cashing Drafts

Credit unions establishing share draft programs may desire to make arrangements with local banks or other financial institutions to cash share drafts under the condition that the credit union provide authorization for each draft cashed. Credit unions becoming involved in this activity must ensure that the authorization is recorded on the member's share draft account at the time it is given. In all cases involving draft cashing programs, the credit union may guarantee payment by adopting the appropriate amendment to Article III, section 5(a) of the Bylaws excluding share draft accounts from the 60-day notice requirement. This is considered commercially necessary to permit the effective use of share drafts in the marketplace. The wording of the standard amendment is:

> "The board shall have the right, at any time, to require members to give, in writing, not more than 60 days notice of intention to withdraw the whole or any part of the amounts so paid in by them except for those amounts paid into share draft accounts."

Although a Federal credit union may only cash the checks of its members, this does not prevent the cashing of member share drafts by nonmembers. In this instance the credit union is simply honoring an authorized withdrawal presented by the nonmember/payee.

### 10.3-2.8 Fees

Credit unions offering share drafts to their members may charge periodic fees or service charges to their members using share drafts. Charges may be assessed for services, e.g., distribution of interim statements, processing stop payment orders, overdrafts, obtaining copies of paid drafts for a member and for the actual cost of the blank share drafts furnished to each member.

Fee structures are within the purview of the board of directors of the credit union implementing a share draft program and should reflect both equity and the spirit of cooperative principles.

### 10.3-2.9 Internal Accounts

Federal credit unions are not permitted to establish their own in-house accounts upon which drafts may be drawn since the Bylaws require all funds of the credit union except for petty cash or change funds, to be deposited.

Notwithstanding the above, a Federal credit union may draw drafts upon itself. The particular type of draft permissible would be the functional equivalent of a cashier's check which is a draft drawn by a bank against its assets. The bank is both the drawer and the drawee of the instrument. It becomes the bank's primary obligation and constitutes its written promise to pay on demand. Although a Federal credit union may not issue cashier's checks because it could not provide checking services, it may issue what might be termed "treasurer's drafts" to make credit union payments. Therefore, while a Federal credit union may draw drafts upon itself, assuming proper accounting procedures and an awareness of any liability that may be incurred by doing so, it may not have its own internal share draft account.

### 10.3-3 Share Certificates

A share certificate account is an account which earns a dividend at a specified rate if held to maturity. The dividend rate may be fixed or variable. A penalty may be assessed for the early withdrawal of all or any portion of the principal amount prior to maturity. Additionally, share certificates usually require a minimum balance. Therefore, the distinguishing features of a share certificate account may be listed as:

(1) Specified dividend rate;

(2) Maturity date;

(3) Penalty provisions; and

(4) Minimum balance.

A minimum balance or denomination is used to attract new and larger share accounts or to stabilize present share deposits. A maturity date is used to retain shares over a predictable period of time. This would allow for better planning and controlling of share capital. The use of a penalty provision is to raise the cost of withdrawing from stabilized share accounts, thus discouraging disintermediation. All of these attempts to increase and stabilize share capital is at the expense of paying a higher dividend specified in advance or contracted for. The greater the restrictions on a certificate account, the higher the dividend rate necessary to induce members to participate. If the maturity date is too long, the minimum balance or denomination too high, or the penalty provision too stringent, members will not participate. This may lead to members seeking other alternatives outside the credit union and ultimately, disintermediation.

### 10.3-4 Money Market Accounts

A money market account is a short-term, insured draft account designed to pay competitive money market rates. Terms and conditions are determined by the credit union according to competition and to its own resources. Such accounts are similar to those offered by banks and savings and loan associations.

General characteristics of a credit union money market account include:

(1) Competitive yields (money market rates);

(2) Short-term or no maturities;

(3) Frequent dividends (e.g., daily);

(4) Minimum balance, deposit, and withdrawal requirements, as determined and established by the credit union;

(5) Share insurance;

(6) Draft access; and

(7) Penalties, as determined by the credit union, if the account falls below the minimum balance requirements.

Due to the nature of money market accounts, (i.e., short-term, rate sensitive) a credit union offering them will need to develop an effective asset-liability management approach. It is essential that these accounts be matched with assets of similar characteristics. Achieving a favorable arbitrage or spread is vital to the success of the program. Adequate liquidity and safety are also of vital concern. Asset-liability management is discussed in section 6.

### 10.3-5 Individual Retirement Accounts

Part 724 of the Rules and Regulations authorizes a Federal credit union to act as trustee or custodian of Individual Retirement Accounts for its members or groups or organizations of its members. An Individual Retirement Account (IRA) must be treated as a trust or custodial account; the instrument creating the trust must be in writing; and the funds must be invested in share accounts or share certificate accounts of the Federal credit union. The share and/or share certificate accounts can be designed in any manner the credit union chooses, without any maturity or dividend restrictions.

Rules pertaining to IRAs are subject to frequent change. Up-to-date information can be obtained from the Internal Revenue Service (IRS). The current revision of Publication 590, Tax Information on Individual Retirement Arrangements, contains information regarding eligibility requirements, kinds of IRAs, current limits on tax deductible contributions, etc. This publication can be obtained from the IRS.

### 10.3-5.1 Types of Individual Retirement Accounts

The following types of Individual Retirement Accounts (IRA) may be found in credit unions:

(1) Accumulation IRA. Also referred to as a Contributory IRA. Any member who has earned compensation at some time during the year may be eligible to participate in this type of IRA.

(2) Spousal IRA. This applies to any non-working spouse of a wage-earning member. Contributions to an IRA for a non-working spouse must be contributed to a separate IRA custodial or trust account. The member and spouse may not own the account jointly. Therefore, the spouse must be eligible for membership in the credit union.

(3) Rollover IRA. This is a tax-free transfer of cash or other assets from one retirement program to another. There are two kinds of rollover payments to an IRA. One is a transfer of amounts from one IRA to another IRA. This type of rollover is only allowed once every 12-month period. The other is a transfer of amounts from a pension plan (including profit-sharing and stock-bonus plans) to an IRA. Once the rollover is accomplished, the rules pertaining to the type of IRA the amounts were rolled to apply (i.e., accumulation, spousal, etc.).

(4) Simplified Employee Pension (SEP-IRA). This is a retirement plan under which the employer makes contributions to the IRA accounts of all eligible employees.

Specific rules regarding the above types of IRA accounts can be found in IRS Publication 590, Tax Information on Individual Retirement Arrangements.

### 10.3-5.2 Contributions

The trust or custodial agreement must provide for contributions within the limits of applicable laws and regulations. In addition, the agreement must provide for a time for final distribution.

If the credit union maintains a trust for an employer or for an association the IRS requires that the credit union maintain records which show the contributions for each individual included in the trust.

### 10.3-5.3 Tax Exemptions

Contributions to Individual Retirement Accounts are tax deductible and earnings on IRAs are not taxed until distribution is made or a transaction occurs which would cause the tax sheltered status to be forfeited. Unless a person becomes disabled, premature distribution to the account holder before a fixed age is subject to a tax penalty. In addition, if an IRA is pledged as security on a loan, the portion pledged must be treated as a distribution and is taxable to the individual. The credit union must file reports whenever there are distributions from an IRA account. Form W-2P is filed with the Social Security Administration and a copy given to the individual when partial distribution of a retirement account is made. Form 1099R is prepared when total distribution is made. Copies of these forms must be given to the individual by January 31 and to the IRS by February 28 following the close of the year.

### 10.3-5.4 Annual Reports

The credit union is required to make an annual report to the IRA participant on transactions occurring during the calendar year. The report must contain the following information:

(1) The aggregate amount of contributions;

(2) The aggregate amount of distributions;

(3) The name and address of the credit union; and

(4) Any other information the IRS may specify.

This report must be given to the member by June 30 of the year following the calendar year for which the report is required. Although the IRS may require that a copy of the report be filed with the agency, at this time it does not require that a copy be filed.

### 10.3-5.5 Credit Union Employees' Retirement Plans

A Federal credit union can provide retirement benefits for its employees and officers who are compensated. It should be noted that except for IRA and Keogh Accounts, credit unions have no authority to act as a trustee over any trust accounts. Therefore, where credit union employees and compensated officers are involved, a Federal credit union can only become involved in the following types of pension plans:

(1) As the sponsor of an employee pension benefit plan with a named trustee other than the credit union.

(2) As the trustee or custodian for Individual Retirement Accounts for employees and compensated officials of the credit union.

### 10.3-5.6 401K Plan

Part 724.0 of the NCUA Rules and Regulations provides for development of pension plans which qualify under 401(d) or 408 of Internal Revenue Code. As a result, credit unions have begun to offer services in the deferred compensation field. 401K Plans are known as "pay conversion plans", deferred pay plans, or salary reduction plans. The 401K plan is being offered by most major corporations to their employees. In some credit unions the growth in this program is offset by a reduction of payroll deduction deposits in credit unions. The 401K plan has a distinct advantage over IRA's in that the per year maximum may be much greater than the IRA maximum and the availability of the funds is improved. The idea is to reduce current tax obligations by reduction of gross wages.

Other deferred compensation plans have begun to emerge with credit union involvement. Normally, the credit union is custodian or trustee of the fund. Basic information relating to this type of program may be found in the Accounting Manual, Section 6080. In order for a credit union to act as trustee or custodian, the plan must consist of IRAs. However, in April 1982, Legal Services ruled that a credit union could act as custodian for public unit funds placed in a credit union through a deferred compensation program. Part 745.9-3 of the NCUA Rules and Regulations, Deferred Compensation Accounts, limits insurance to $100,000 per plan participant who is a member. This coverage is separate from other accounts.

Whenever an Examiner encounters a program such as the above, care should be taken to be certain the financial soundness of the credit union is not threatened. A copy of legal opinions, contracts, and other pertinent data should be sent to the SE, and the regional office.

### 10.3-6 Organizational Accounts

A review of organizational accounts is made to ensure compliance with Article XVIII, section 2(b) of the Bylaws. The Bylaws state that for an organization to be eligible for membership in a credit union, the organization must be composed exclusively of persons who are within the field of membership. This is normally determined by the examiner on the basis of information obtained from the organization. In the event it is questionable whether the organization meets the Bylaw definition, the credit union could apply for a charter amendment to specifically add the group to its field of membership.

Organizations which meet the eligibility requirements can borrow from the credit union, but not in excess of the organization's shareholdings in the credit union. However, it should be noted that older versions of the Bylaws permitted loans in excess of shares to organizations. Credit unions with charter numbers lower than 14662 may have the older Bylaws.

### 10.3-7 Escrow Accounts

An escrow account is normally established in conjunction with real estate loans and as a limited access share account. "Escrow account" means either a special limited withdrawal share account or an accounts payable account for the accumulation of funds to pay for taxes, assessments, insurance premiums, construction proceeds or other charges that could affect the credit union's first lien position.

The amount that a Federal credit union can require a borrower to place in an escrow account is limited as defined in the Real Estate Settlement Procedures Act of 1974 (RESPA). As stated in this Act, the escrow account must provide for the accumulation of funds to pay for not more than 1-year's taxes, assessments, insurance premiums or other charges that could affect the credit union's first lien position.

At the time the account is opened, the member-borrower is required to sign a blanket withdrawal authorization which permits the credit union to use the funds to make the required payments. The credit union must also arrange to have each borrower for whom an escrow account is maintained promptly submit to the credit union for payment any statements received by the borrower relating to taxes, assessments, insurance premiums and other fees which are to be paid from the escrow account. Any disbursement made from an escrow account must be supported by such documents. Shares in escrow accounts may not be pledged as security for loans nor may such shares be applied to loans which are delinquent. If the borrower is required to maintain an escrow account, that account will earn dividends.

### 10.3-8 Nonmember Accounts

Nonmember accounts consist of shareholdings of other federally insured credit unions and, in a credit union designated as a "low income" (i.e. serving predominantly low income members) credit union, the shareholdings of nonmember individuals or organizations.

### 10.3-9 Public Unit Accounts

A credit union may receive payments on shares from member or nonmember units of Federal, state and local governments. Because these funds tend to be in large amounts and are subject to immediate redemption, they need to be carefully analyzed. The term "public unit" means the United States, the District of Columbia, any state of the United States, the Commonwealth of Puerto Rico, any territory or possession of the United States, any county, municipality, or political subdivision thereof. The term "political subdivision" includes any subdivision or principal department of a public unit:

(1) The creation of which subdivision or department has been expressly authorized by state statute;

(2) To which some functions of government have been delegated by state statute; and

(3) To which funds have been allocated by statute or ordinance for its exclusive use or control.

### 10.3-9.1 Treasury Tax and Loan Accounts

Credit unions can be designated as a Treasury Tax and Loan (TT&L) depository. The authority to establish a TT&L account is set forth in section 701.37-1 of the Rules and Regulations. A credit union cannot become a TT&L depository until it receives the approval of the Federal Reserve Bank (FRB) in the district in which the credit union is located. To receive approval, the credit union must file an "Offer to Contract and Application" with the Federal Reserve District Bank. A resolution from the credit union's board of directors authorizing the "Offer to Contract and Application" must accompany the form.

READEX

There are two types of accounts in which a credit union may participate, but it can only participate in one at a time. If the credit union wishes to change the type of account, it must notify its Federal Reserve Bank. The two types of accounts are:

(1) The TT&L Remittance Account - This option account is used for receipt of payments of Federal taxes and certain U.S. obligations. Funds credited by the credit union to this account will be withdrawn by the Federal Reserve Bank immediately upon receipt of advices supporting such deposits. This account will not receive dividends and the funds are not subject to the 60-day notice requirement of Article III, section 5(a) of the Federal Credit Union Bylaws.

(2) TT&L Note Account - Funds held in this option account will be in accordance with the Department of the Treasury Regulations. These funds represent an investment in the depository by the Treasury and will be evidenced by an open-end, interest-bearing note maintained at the Federal Reserve Bank in the district where the depository is located. In addition, other funds from the Treasury's operating cash may be offered from time to time to certain Note Account depositories which shall have the opportunity to decide whether they wish to receive from the Treasury such additional investments in their notes. Also, a TT&L depository may credit funds to its note representing payments for U.S. Savings Bonds issued by the credit union in its issuing agent capacity and payments for U.S. Savings Bonds subscribed for through the TT&L depository on behalf of its members, but which may be issued only by a Federal Reserve Bank and the U.S. Treasury Department. The rate of interest will be specified by the Treasury. These funds are subject to immediate withdrawal and the Treasury will call for them to meet its cash needs. The frequency of calls for funds depends upon the credit union's annual volume of activity in the account, and can range from daily to three or four times a month. Since these funds are highly volatile, credit unions should be cautioned not to place them in long-term investments. Funds held in this type of account will not be considered borrowing for purposes of Section 107(9) of the Act, and will not be subject to the 60-day requirement of Article III, section 5(a) of the Federal Credit Union Bylaws.

The Treasury will compensate credit unions for each transaction handled by them. If required, a credit union can pledge specifically identified assets as collateral for TT&L accounts and may enter into such custodial arrangements as may be necessary to meet Department of Treasury requirements for collateral on TT&L accounts.

If the credit union is a TT&L depository, the examiner should determine that:

(1) A copy of the application and board of director's resolution authorizing the credit union to be a TT&L depository is on file;

(2) Remittances are made to the Federal Reserve Bank as required by the U.S. Treasury Department;

(3) Collateral pledged to the U.S. Treasury Department is footnoted as such on the credit union's Statement of Financial Condition; and

(4) The monthly statement received from the Federal Reserve Bank is reconciled. Federal Reserve Banks will furnish a monthly statement on or about the twentieth of each month to each TT&L depository concerning compensation to be paid and payments due the Treasury. The statement will include:

   a. The number of Federal tax deposit forms upon which the compensation is based;

   b. The fee factor;

   c. The total compensation to be paid; and

   d. Interest on late fees due the Treasury.

### 10.3-9.2 Depository and U.S. Agent Account

A Federal credit union may act as a depository or financial agent of the U.S. Government under the provisions of Section 31, C.F.R. 202 of the Department of Treasury Regulations. When acting under this authority, Federal credit unions are permitted to:

(1) Maintain accounts as may be specified by the U.S. Treasury in which balances may exceed the insurance coverage provided for in Section 207(c)(2)(A) of the Act.

(2) Maintain accounts in the name of the U.S. Treasury. Such accounts may include:

   a. A Treasury General Account in which a zero balance may be maintained and from which the entire balance may be withdrawn by the depositor immediately, under all circumstances except closure of the credit union;

   b. A U.S. Treasury Time Deposit-Open Account which may be nondividend-paying and which may be withdrawn prior to the expiration of 30-days' written notice from the U.S. Treasury.

(3) Accept deposits to these accounts for the credit of the U.S. Treasury.

(4) Furnish drafts in exchange for collections in these accounts; and

(5) Pledge specifically identified assets as collateral to secure public funds under provisions specified in 31 C.F.R. 202.6.

For share insurance purposes, funds in a Treasury General Account and the U.S. Treasury Time Deposit-Open Account are considered public unit funds and as such, are insured up to a maximum of $100,000 in the aggregate. Share insurance premiums must be paid on the total amount of funds in these accounts.

Funds held in a U.S. Treasury Time Deposit-Open Account are not considered borrowings for purposes of Section 107(9) of the Act, and are not subject to the 60-day notice requirement of Article III, section 5(a) of the Bylaws.

The sum of the amounts in these type accounts must not exceed 10 percent of the total assets of the credit union.

### 10.3-10 Brokered Funds

A detailed discussion of brokered funds can be found at section 6.2 of the Guide.

### 10.4 Advertising and Disclosures

A Federal credit union must accurately represent the terms and conditions of its share, share draft and share certificate accounts in all advertising, disclosures or agreements, whether written or oral.

### 10.5 Workpapers and References

(1) Workpapers

  a. NCUA 2055, Examination Checklist

(2) References

  a. Federal Credit Union Act

    1. 107(6) - Receipt of Funds
    2. 117 - Dividends

  b. Federal Credit Union Bylaws

    1. Article III - Shares of Members
    2. Article XII, Section 1 - Loans to Members (Organizations)
    3. Article XIV - Dividends
    4. Article XVIII, Section 2(b) - Organizations of Such Persons

  c. NCUA Rules and Regulations

    1. 701.19 - Retirement Benefits for Employees of Federal Credit Unions
    2. 701.35 - Share, Share Draft and Share Certificate Accounts
    3. 701.37-1 - Treasury Tax and Loan Accounts
    4. 701.37-2 - Government Depositories and Agents
    5. 724 - Trustees and Custodians of Pension Plans

## 11. Cash Analysis

Cash operations generally account for the most frequent type of credit union transaction. Cash can be easily transported, concealed and converted into other types of assets. For these reasons, a credit union must have procedures in place to supervise the flow of cash from the time it is received, through its various stages of use and custody to its final disbursement. Similar procedures also must be instituted by credit unions which sell negotiable items such as travelers' checks, money orders, savings bonds and food stamps.

Objectives during a review of cash are to determine that:

(1) Accounting policies, practices, procedures and internal controls regarding all phases of cash operations are adequate to protect cash items;

(2) Credit union officials and employees are operating in accordance with established guidelines;

(3) Corrective action is initiated when accounting policies, practices, procedures, or internal controls are deficient.

The examiner's review of cash operations is not intended to discover cash shortages. However, if a cash shortage is discovered during the review process, the examiner will notify the board of directors and the supervisory committee and determine that the officials take the appropriate action to conduct an audit and to file a surety bond claim.

### 11.1 Examination Procedures

The extent of the examiner's analysis of cash will depend upon the quality of cash policies, practices and internal controls, the condition of the cash records, the degree and materiality of cash transactions and the degree of problems disclosed by previous audits or examinations. The examiner should be satisfied that cash items are accurately and timely transacted and recorded. The examiner will record the review of the cash analysis on NCUA 2055, Examination Scope.

The analysis process should be designed to uncover major weaknesses in critical areas of a credit union's cash operation. If the examiner discovers a problem during the initial review that is critical the review should be expanded.

The examiner's conclusion of major weaknesses should be supported by adequate documentation. If management and/or officials take corrective action during the examination, appropriate comments should be noted in NCUA 2030, Examination Overview. If corrective action has not been made, the examiner should consider the need to develop an appropriate Record of Action, as well as comment in the Examination Overview.

If the review process reveals that a material adjustment is needed to a cash account, the examiner will document it in the examination report. To avoid any conflicts, any adjustment to the credit union's records should not be entered by the examiner. When possible the examiner should have the treasurer make the adjustment during the examination.

## 11.2 Bank Reconcilements

In most cases, the most recent month's end bank reconcilement should be analyzed by the examiner. However, if the examination is started on or before the tenth working day since the most recent bank statement was received, and the bank reconcilement as of that date has not been prepared, the examiner may accept the bank reconcilement as of the previous statement. However, the examiner should attempt to have credit union personnel prepare a reconcilement as of the effective date of the examination.

If the bank reconcilements are more than 60 days delinquent, the examiner should determine the cause; agreements should be reached to bring the reconcilements current, usually within 30 days. The actual time frames and the person responsible for bringing the reconcilements current are up to the examiner. An outside, independent auditor should be suggested to bring the reconcilements current where there have been no reconcilements for 6 months or more. Arrangements should be made with the board and supervisory committee to have this task performed promptly.

The examiner's review of the bank reconcilement may include tracing the cash balance per books to the General Ledger and the cash balance per bank to the bank statement. Adjustments may be traced to determine validity and proper clearance. Also, outstanding checks and deposits in transit may be verified. The extent of the examiner's review will depend upon the credit union's internal control procedures. Completion of the review will be recorded on NCUA 2055, Examination Scope.

## 11.3 Credit Balance in Cash Account

If there is a credit balance in the cash account as of the effective date of the examination, but the bank account is not overdrawn, no adjustment is required. Likewise, if the bank account actually is overdrawn, but is overdrawn only on infrequent occasions and for short periods of time, no adjustment should be made.

On the other hand, if the bank account is overdrawn as of the effective date of the examination and it is determined that such overdrafts occur regularly, an adjustment should be made for the amount of the actual bank overdraft. Accounts Payable or Notes Payable (whichever is applicable) should be credited and the officials should make an adjustment as of the end of each month to properly reflect the liability.

Some banks may enter into a written agreement with the credit union either by means of a contract extending a line of credit, or by a letter indicating the bank's willingness to honor checks drawn by the credit union even though sufficient funds have not been deposited. The examiner should not be critical of such an arrangement if it is to the credit union's advantage to borrow in this manner.

If there is no written agreement, the officials should understand the risks involved when the credit union's cash account is overdrawn. The practice should be discontinued since it could result in an actual bank overdraft and in bad publicity if checks drawn to members or other parties were not honored by the bank because of insufficient funds. The same situation exists even if there is an informal agreement (non-written) or simply an understanding between the credit union and the bank that the latter will honor such checks. Such arrangements hardly could be binding.

If the credit union is indebted frequently through this type of borrowing, whether by written agreement or otherwise, the impact that it may have on the credit union's liquidity position and operating costs should be analyzed thoroughly by the examiner. Dependence upon this type of credit for extended periods of time may point to operational weaknesses that warrant appropriate attention.

### 11.4 Money Orders/Travelers' Checks

If the review of money orders or travelers' checks discloses the possibility of a substantial difference and no current count or reconcilement has been made, the examiner should reach agreements to have the reconcilements completed, preferably by an outside auditor. When the examiner believes there is a need to prove the accuracy of the latest reconcilement completed by the credit union, one of the following workpapers should be prepared. A reconcilement should not be done by the examiner as a routine examination step.

MONEY ORDERS

On hand per settlement_____ Number___
Date

Add: Consignment received
since settlement date

Less: Sales and voids since
last settlement

Total (must agree with
teller's records)

TRAVELERS' CHECKS (Also can be used for SAVINGS BONDS)

| | | | | | | |
|---|---|---|---|---|---|---|
| | | Number | | | | |
| | $10 | $20 | $25 | $50 | $100 | Total |
| On hand per settlement_____<br>Date | | | | | | |
| Add: Consignments received<br>since settlement date | | | | | | |
| Less: Sales and voids since<br>last settlement | | | | | | |
| Total travelers' checks/food stamps<br>(must agree with teller's records) | | | | | | |

### 11.5 Food Stamps/Savings Bonds

Food Stamps and Saving Bonds are encountered infrequently in credit unions. However, the examiner should insure that internal control procedures are in place for these activities.

## 11.6 Treasurer's Drafts

The term Treasurer's draft is used to describe drafts issued by a credit union against itself. The treasurer's draft is used by the credit union in the same manner it would use a checking account held at a bank. The credit union is not establishing a share draft account for itself at the credit union, it is merely issuing drafts which it promises to honor when properly presented. The treasurer's draft is an alternative to the checking account at a bank and will allow the credit union to use the float to its own advantage.

### 11.6-1 Treasurer's Draft Activity

Treasurer's drafts are established by setting up a separate clearing account for the drafts at the payable-through bank that is clearing the members' share drafts for the credit union. The drafts are cleared in the same manner that the members' share drafts are cleared. The credit union issues drafts for all loan disbursements, share withdrawals, and payment of expenses. When a draft is issued, the appropriate account is debited (loans, shares, or expense) and Account 805, Treasurer's Drafts Payable, is credited. As drafts are received by the payable-through bank, the drafts are paid from the deposit account maintained at the bank by the credit union. As an alternative, the credit union may maintain a settlement account in some other institution in place of the deposit account at the bank. (See subsection 10.3-2.6 for other settlement accounts.) The bank notifies the credit union which drafts have cleared and the credit union debits Account 805 and credits the deposit/settlement account for the amount of the cleared drafts.

In some credit unions, the settlement process is completed by a direct charge to a specific share draft settlement account at the credit union. The share draft settlement account is then used in place of Account 805, Treasurer's Drafts Payable, and would be listed as Account 73x (cash) or Account 74x (Investments) in the General Ledger. The amount of uncleared Treasurer's drafts, however, must be reflected in Account 805, Treasurer's Drafts, as a liability on the financial statement.

### 11.6-2 Examination Procedures

The examiner's review of corporate drafts should include an analysis of the reconcilement of the payable-through bank deposit account or settlement account and the reconcilement of Account 805. The methods used to analyze these accounts will be the same as those outlined in subsection 11.1 and 11.2.

### 11.6-3 Official Checks

This program is offered by Travelers Express to credit unions. Basically, each day the credit union writes drafts payable through a bank; at the end of the day the total of the drafts written is wired to Travelers Express bank account. This covers all outstanding checks. The credit union earns income on the float and once a month a list of draft items not cleared is sent to the credit union. This list is normally used as the outstanding check list for the month. It does not eliminate the cash reconcilement function. This program is not prohibited by NCUA, but the board of directors should be cautioned that default by the remitter of the draft (Travelers Express) could have serious effects upon the FCU's financial condition and reputation.

## 11.7 Federal Reserve's Payment System Risk Program

On May 17, 1985, the Board of Governors of the Federal Reserve System issued a policy statement on the control and reduction of risks to depository institutions participating in large-dollar wire transfer systems. The policy statement, which became effective on March 27,1986, calls on depository institutions to reduce the credit risks associated with their participation in these systems and defines the role that the Federal Reserve and other financial institution regulatory agencies will plan in monitoring, examining, and counseling depository institutions.

By way of background, there are five large-dollar wire transfer systems currently in operation-Fedwire, CHIPS, Cashwire, CHESS, and PRESS. Together these five systems handle almost $600 billion a day in wire transfers. The bulk of this volume is on Fedwire and CHIPS. Fedwire process an average of 150,000 transactions with an aggregate value of over $350 billion. CHIPS processes about 75,000 payments a day with an aggregate value in excess of $200 billion. Most credit unions utilize the service of a correspondent bank or corporate credit union to move funds by a wire transfer system. Although this may result in some operational changes, i.e., delay in transfer and receipt of funds, these credit unions would not be subject to this program. This program is applicable to those credit unions that have direct access and utilize the wire systems to make transfer of funds. It should be noted that the Fed, based on data received from credit unions, stated that only a few credit unions have daylight overdrafts, therefore, monitoring will be the only issue for NCUA. In addition, corporate central credit unions are currently considered "bankers" banks by the policy statement. This requires corporates to fully collateralize any daylight overdrafts.

On any of the payment systems, a sending institution may be unable to settle its obligations by covering the payments it has sent in "good" funds by a specified time. On Fedwire, pursuant to Regulation J, all transfers are final and irrevocable when the Reserve Bank sends notice of the payment to the receiving institution. Therefore, the receiving institution can pass collected funds immediately to its customer and will bear no risk if the sending institution fails. If the sending institution has insufficient funds in its reserve account at the tme the payment order is initiated, it incurs a "daylight overdraft." If the sending instituiton fails that day before bringing its reserve account into balance, the Federal Reserve Bank absorbs the loss. This risk that failure of a system participant to settle its net debit position will affect others is referred to as systematic risk.

On an average day, daylight overdrafts at all institutions are between $110 and $120 billion. Overdrafts resulting from transfers of book entry U.S. Government securities on Fedwire (currently excluded from the policy guidelines) range between $30 and $40 billion per day. The remaining $75 to $85 billion of daylight overdrafts are distributed $45 to $55 billion on Fedwire and $30 to $40 billion on private wire system.

Against this backdrop, the Federal Reserve System and industry groups have been pursuing efforts to reduce the risks associated with the operation of large-dollar payment networks. The major objective of the Board's policy statement was to reduce the risk of a settlement failure. The policy statement seeks to achieve this goal through a reduction in the level of daylight overdrafts and by encouraging institutions to exercise better control over the remaining credit exposure.

The policy statement encourages each depository institution that incurs daylight overdrafts to voluntarily adopt a "cross-system sender debit cap." The cap represents the maximum net debit which a depository institution may incur at any one time on all of the large-dollar wire transfer systems in which it participates (Fedwire and each private network). The cap limits the amount by which an institution's outgoing wire transfers may exceed the value of the transfers it has received across all systems combined.

Under the policy statement, depository institutions are encouraged to establish their net debit cap based on a self-assessment of three criteria: (1) creditworthiness, (2) operational controls, policies, and procedures, and (3) credit policies and procedures. Based on the depository institution's evaluation of its strength in these three areas, an overall assessment is determined. In establishing its sender net debit cap, a depository institution is expected to maintain supporting documentation, a back-up file, of its self-assessment and evidence of its board of directors' review and approval of the cap selected.

The Fed is currently in the implementation stage as of this writing. The liaison officer at each Fed Bank will contact his/her counterpart at NCUA to exchange information on the caps established by credit unions. If the cap appears excessive, the Fed will ask the Region to review the back-up file and determine if the basis for the cap is reasonable. The Fed will council credit unions that have daylight overdrafts that exceed the caps, but will only contact NCUA on significant problems. The Fed will develop standard reports so that NCUA can monitor the overdraft activity.

Since there are only a few credit unions that will be subject to this program, specific examiner training will be provided to a limited number of examiners in each region. It will be their responsibility to review this area during the examination. The regional office will provide these examiners, and their supevisors, with the Fed's overdraft activity report. During each examination, the examiner will:

(a) determine if the credit union has direct access to the Fedwire;
(b) determine if the credit union incurs daylight overdrafts;
(c) determine that the credit union has established a cap. If not, review the daylight overdraft activity to determine if it creates a safety and soundness problem. If so, address as a problem area during the exam;
(d) review self-assessment file and creditworthiness analysis to determine that its reasonable and in accordance with Fed procedures (see Appendix I for Fed's guidelines for determining creditworthiness);
(e) review management reports and board minutes to determine that the credit union board has approved the cap; and
(f) review the activity on the Fedwire to determine that the credit union is in compliance with their self-assessment policy.

To assist in reviewing the Payment System Risk Program, NCUA 2431 will be completed for each credit union that has direct access to the Fedwire.

## 11.8 Workpapers and References

(1) Workpapers

- a. NCUA 2055, Examination Scope
- b. NCUA 2265, Cash and Internal Controls
- c. NCUA 2431, Federal Reserve's Payment System Risk Program Worksheet

(2) References

- a. NCUA Rules and Regulations
  - 1. 702.3 - Full and Fair Disclosure
- b. Accounting Manual for Federal Credit Unions

## D. Credit Unions

Credit unions are able to use the published data available from the National Credit Union Administration for peer comparisons. Large credit unions that provide a full range of customer services may also want to pay particular attention to commercial bank peers which they may often resemble. Sponsorship/affiliation may also be significant in some cases. Special attention should also be given to the potential risks associated with a plant/business closing that could adversely affect the entire membership or a significant block of it.

## CASE 9 - CREDITWORTHINESS

### Credit Union

ABC Federal Credit Union is an occupational credit union located in a small industrial city in an Eastern state. The self-assessment of creditworthiness as determined by the credit union's management, and approved by the board of directors, is as follows:

### Peers

ABC's peer group is composed of occupational credit unions in the $10 million to $20 million asset range. There are currently 495 credit unions in this peer group. Peer data are developed by and published by the National Credit Union Administration.

### Asset Quality

The level and severity of classified assets detailed in the latest examination of the NCUA is low. Classified loans total $18,100 or .2% of a total loan portfolio of $9,050,000. The classified loans (all loss) consist of four small loans to members.

Loan delinquencies continue to be low. NCUA data reveals that delinquent loans were .8% of total loans in 1984 compared with a peer group average of 2.0%. Our delinquency rate over that past five years has ranged from a low of .5% in 1980 to a high of 1.2% in 1982.

Loans charged off also continue to be low. In 1984 net charge-offs were .2% of average loans compared with peer group average of .3%. Over the last five years, the charge-off rate has ranged from .0% in 1981 to .3% in 1980. These low charge-offs indicate that the credit union has effective lending and collection practices. NCUA examiners, at the time of their last examination on January 15, 1985, stated to management that the lending and collection programs were good and that there were effective policies and procedures over the loan operation.

The allowance for loan losses account totals $22,500 and more than covers the current classified loans.

Based upon the credit union's low delinquency and charge-off rates, low volume of classified loans, and satisfactory lending and collection programs, the credit union is rated "Very Good" in asset quality.

## Capital

Many members have only recently been recalled by the sponsor after an extended layoff. While loans have increased dramatically since the recall, capital, has not kept pace. The credit union has experienced record loan growth over the past year. Loan volume has increased from $5,100,000 in 1983 to $8,900,000 in 1984 - an increase of 74.5%. The growth has occurred due to optimism about the improving economy and the very competitive lending rates offered by the credit union.

A substantial portion of the funding for the increased loan demand has come from funds that had been invested in CD's of other financial institutions rather than from an increase in member shares. Loan growth is expected to continue to be strong for the foreseeable future.

The dramatic increases in loans outstanding has resulted in the growth of noncash assets (CDs of $100,000 at insured institutions are treated as cash) exceeding reserve growth even though large increases have been made in the reserve accounts. The five-year compounded growth rate of reserves and undivided earnings minus that of loan growth was a negative 4.3% resulting in a percentile ranking of 15, which is low, when compared to the credit union's peer group. The board of directors has attempted to correct this by authorizing larger transfers to the regular reserve account.

Total capital, excluding the reserve for loan losses, totals $550,000, which is 5.2% of total assets.

Based upon the credit union's current capital position which is below peer and the recognized need to increase these amounts to keep pace with asset growth, the credit union is rated only "Adequate" with respect to capital.

## Earnings

A higher than peer group yield from assets has resulted in the payment of good competitive dividends and substantial recent increases to the reserve accounts. Net income totalled $110,200 for 1984, and was 8.5% of gross income compared with a peer group average of 6.7%. Approximately 70% of gross income came from loans made to the credit union members with most of the remaining income coming from investments in U.S. Treasury notes, municipal securities, and deposits in other depository institutions.

The credit union's payout ratio, or dividends as a percentage of gross income, was 55.7% in 1984. This payout ratio ranked the credit union at the 38th percentile for its peer group, slightly below average. Dividends were reduced in order to provide for a larger increase in reserves needed to help keep pace with the large growth in assets.

Total reserves and undivided earnings in 1984 increased 35% from 1983. Growth in this category in 1984 ranked the credit union at the 71st percentile for its peer group.

Based upon the credit union's strong earnings performance in relation to its peers and its conservative allocation of income among dividends and reserves, the credit union is rated "Very Good" with respect to earnings.

## Overall Creditworthiness Assessment

| | |
|---|---|
| Asset Quality | Very Good |
| Capital | Adequate |
| Earnings | Very Good |
| Preliminary Creditworthiness Grade | Very Good |

## Liquidity

Adequate liquidity in the form of cash, deposits in banks and other credit unions, and U.S. Government and Agency securities has been maintained. These assets total $1,250,000 or 11.9% of total assets. The credit union's funds management program has been rated satisfactory by the regulators. Liquidity is rated a neutral factor and, therefore, does not affect the preliminary creditworthiness rating.

## Affiliation

The credit union is independent from the sponsor and has neither received support nor asked for support from the sponsor since its formation. The limited but serviceable office space provided by the sponsor is contractually provided as an employee benefit under the labor agreement.

## Overall Assessment

The overall assessment of creditworthiness is consistent with an above average cap.

## Examiner's Comments

While in general agreement with the overall assessment, the absence of supporting statistics beyond those included in the test makes an independent analysis difficult. Capital, graded "adequate," appears somewhat low for this rating. If it continues to lag the growth in assets, a downgrading at the next assessment appears likely. On the other hand, asset quality is quite strong. More data -- both current and historical -- might well support an upgrading of this factor. ABC is encouraged to document its file more completely, and to look closely at both asset quality and capital at its next director review of the self-assessment.

## E. Branches and Agencies of Foreign Banks

Unlike other institutions participating in the large payment systems, branches and agencies of foreign banks lack a true U.S. corporate entity against which risk can be evaluated. As a result, the self-assessment is necessarily based upon the foreign based corporate entity to which the branch(es) and/or agency(ies) belong. Such analysis looks to the consolidated entity[34] and all branches and agencies of that entity are combined[35] for purposes of developing a single assessment and adhering to cross-system net debit caps. A single cap is thus obtained.

For foreign banks with access to the large payment systems in more than one Federal Reserve District, a single branch or agency and Reserve bank will be designated as the primary contact points for administering this program. That branch or agency will maintain the self-assessment file for all branches and agencies of the same foreign bank for the examiner review. The Administrative Reserve Bank will be responsible for monitoring the consolidated position for all branches and agencies of the foreign bank. Further instructions regarding the designation of this primary contact point will be provided to all affected institutions early on in the fourth quarter of 1985.[36]

Foreign banks usually lack the type of peer data generally available for domestic institutions. Even where it does exist, the data rarely correspond to that of U.S. counterparts because of different accounting standards. Nonetheless, the absence of peer data does not absolve foreign institutions from going through the same type of analysis as their U.S. counterparts. Indeed, the same general expectations on performance relative to peers -- and that means U.S. peers as well as home country peers -- are present for foreign banks as for domestic institutions if they expect to rate themselves "very good" or "excellent." (Peer data like that suggested for U.S. commercial banks may be appropriate.)

---

[34] Depository institution subsidiaries of foreign banks chartered in the U.S. with direct access to the payments system and subject to their own self-assessments would need to be backed out to avoid double counting.

[35] The way in which the branches and agencies are combined may vary depending upon the way the U.S. operations are organized. At a minimum, it will be necessary to bring together, in a meaningful way, the separate supervisory view of offices subject to different supervisory jurisdictions. Some organizations may also wish to take a more consolidated approach to the data for their U.S. branches and agencies in relating such operations to the foreign parent. Such an approach is permissible as long as it does not obscure issues of supervisory jurisdiction.

[36] Although branches and agencies currently represent the largest class of organizations with interdistrict operations, the same principle applies to Edges with interdistrict branches and a small number of other institutions that operate branches (not affiliates) in more than one Federal Reserve District.

Facts regarding a foreign bank's home country may have significant mitigating considerations particularly where local practices result in substantial "hidden reserves," involve significant government support of institutions, or result in other distortions of financial data in ways that can be shown to indicate different degrees of risk than, in fact, actually exist. Explanations of such factors should be well documented in the examiner's files. While such factors can often cause what would otherwise be regarded as an unsatisfactory rating to be upgraded to satisfactory, further upgrading is unlikely to be acceptable unless the extent of the hidden support is quantified.

If a foreign bank has a deposit-taking institution subsidiary in the United States, that U.S. institution should be evaluated separately, and its data should be backed out of the foreign parent's data before the self-assessment. Thus, the foreign parent should not "double count" either the capital, assets, or liablities of its U.S. subsidiaries in its self-assessment.

The cases documented in this section are illustrative of two basic types of foreign banks with branches and agencies in the U.S. Case 10 is for a world class organization in direct competition with the U.S. multinational banks. Such organizations operate in most, if not all, major financial markets including many outside their home markets. Case 11 is for a foreign bank with a more regional focus. It typically operates primarily in its home country and the region around it, with its U.S. activities primarily directed to support trade or funding in its local area.

12

## 12. Internal Controls

Section 113 of the Act states that the board of directors shall have the general direction and control of the affairs of the credit union. The board is responsible for the proper and profitable conduct of credit union operations, the safety of credit union assets and the accuracy and adequacy of financial statements. The directors themselves cannot normally perform the work resulting from these responsibilities, so they usually retain employees to act for them. However, since the board of directors still retains overall responsibility for the affairs of the credit union, they must establish organizational plans and operating procedures to maintain control over the delegated duties. Such plans and procedures are commonly referred to as internal controls.

Objectives during the review of the credit union's internal controls are to determine that:

(1) The assets of the credit union are being properly safeguarded;

(2) Established credit union policies are adequate and being followed;

(3) The accounting and operational data compiled are accurate and reliable; and

(4) Corrective action is initiated when problems related to weak internal controls are present.

Credit unions should not view internal controls as just a means of preventing fraud or detecting errors in procedures but as an indispensable aid to efficient management. Internal controls should embrace all departments and all activities of a credit union operation.

### 12.1 Appraisal

The examiner's principal efforts in this area should be focused on the detection and correction of important weaknesses in the credit union's operating systems and records. Numerous checklists are available to review internal control in the various areas of credit union operations. These checklists may be used at the examiner's discretion when weaknesses are suspected or were noted at previous audits or examinations.

The examiner may also find it helpful to prepare a written description or flowchart of a particular function in order to evaluate the internal controls. These methods of reviewing internal controls will permit the examiner to see the entire picture. For example, the examiner may want to examine the flow of cash in the credit union from the time it is received to the time it is disbursed. Either method mentioned above could be used to accomplish this task. Since writing a description or preparing a flowchart is time consuming, the examiner should only use these methods when a serious internal control problem is detected and a complete review is needed to identify and correct all of the weaknesses.

## 12.2 Definition

Internal control is divided into two components:

(1) Administrative control includes, but is not limited to, the plan of organization and the procedures and records that are concerned with the decision processes leading to management's authorization of transactions. Such authorization is a management function directly associated with the responsibility for achieving the objectives of the organization and is the starting point for establishing accounting control of transactions.

(2) Accounting control comprises the organizational plan and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial records. Consequently, accounting controls are designed to provide reasonable assurance that;

a. Transactions are executed in accordance with management's general or specific authorization;

b. Transactions are recorded as necessary to:

(i) Permit preparation of financial statements in accordance with generally accepted accounting principles or any other criteria applicable to such statements, and

(ii) Maintain accountability for assets;

c. Access to assets is permitted only in accordance with management's authorization; and

d. The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

The foregoing definitions are not necessarily mutually exclusive because some of the procedures and records involved in accounting control may also be involved in administrative control.

## 12.3 Basic Elements

Each credit union is unique and no one set of internal procedures can be prescribed for all cases. There are, however, certain underlying principles and procedures that should be found in all internal control systems:

(1) Administrative control

A credit union's administration plan must have the approval of the board of directors, establish clear lines of authority and responsibility, segregrate the operating and recording functions and provide employees qualified to perform their assignments. From an administration viewpoint, an internal control system should include the following as a minimum:

a. Accounting System - An accounting system must be adopted that is flexible in its capacity and rigid in its controls and standards. The system must promote accuracy, efficiency and must be cost effective.

b. Directors' Approvals - The credit union's lending, investing and borrowing policies must be written and must clearly establish limitations and authority. Formal income, expense and cash budgets should be reviewed and adopted by the board of directors. This control feature must provide for a reporting system which will keep the directors informed regarding delinquent loans, share and line of credit overdrafts, investment transactions, statements of condition and income, expense and cash flow reports.

c. Cash Control - The amounts of the permanent and temporary change funds must be authorized by the board. Tellers should have sole access to their cash. Common cash funds should not be used and relief tellers should be provided with their own funds.

The participation of two or more persons or departments in a transaction causes the work of one to serve as proof of the accuracy of the work of another. Additionally, when two or more persons are involved in a transaction, the possibilities of fraud diminish considerably. Accordingly, duties should be arranged so that no one person dominates any transaction from inception to termination. As examples: a person handling cash should not post ledgers; a loan officer should not be allowed to disburse the loan proceeds and those having authority to sign checks should not be assigned to reconcile bank accounts.

d. Joint Custody or Dual Control - This feature is established when at least two keys or combinations under the control of at least two different individuals are required to obtain access to vaults, files or other storage devices. It is essential, if dual control is to be effective, that all employees guard their key or combination carefully. If this is done, only collusion can bypass this important control feature. Reserve cash, negotiable collateral, investment securities, safekeeping items, reserve supply of checks, unissued traveler's checks, unissued credit cards, unissued savings bonds, unissued money orders, the night depository, dormant share accounts, safe deposit spare locks and keys, and spare keys to tellers' cash boxes are examples of items that should be under effective dual control.

e. Sound Personnel Policies - The previous employment references of prospective employees should be checked by management. Credit unions should pay adequate salaries and provide competitive fringe benefits. An official should be appointed to discuss personal financial problems with employees, and an atmosphere should be created in which employees feel free to discuss these problems. Written position descriptions which define duties and responsibilities should be in effect for each position.

f. Rotation of Personnel - Planned and unannounced rotation of duties of employees is an important principle of internal control. The rotation should be of sufficient duration to be effective. Rotation of personnel, besides being an effective internal check, can be a valuable aid in the credit union's overall training program.

g. Mandatory Vacations - All credit unions should have a vacation policy which provides that all employees be absent from their duties for an uninterrupted period of not less than 1 week; the indispensable employee is a myth. Perpetration of an embezzlement of any substantial size usually requires the presence of the embezzler in order to manipulate the books, respond to inquiries from members or other employees and otherwise prevent detection.

(2) Accounting controls

An efficient credit union operation cannot be conducted without a recordkeeping system that is capable of generating a wide variety of internal information and reports. Such a system is necessary if a credit union's board of directors is to be kept well informed and if maximum managerial effectiveness is to be achieved.

Forms, records and systems will differ in varying degrees from credit union to credit union. However, the books of every credit union should be kept in accordance with the Accounting Manual and generally accepted accounting principles. In each instance, a credit union's records and accounts should reflect its actual financial condition, structure and accurate results of operations. The following characteristics should be found in a credit union's accounts and records:

a. Operating Responsibilities - The accounting system should be designed to gather information in such a way as to facilitate the preparation of internal reports which correspond with the responsibilities of individual supervisors and key employees.

b. Accounting Manual - Transactions must be recorded in accordance with the Accounting Manual for Federal Credit Unions and generally accepted accounting principles and standards. Transactions must be applied uniformly during each accounting period. Expenses cannot be deferred nor income accelerated in order to increase earnings improperly.

c. Prenumbered Documents - Sequentially numbered instruments should be used for items such as checks, cash receipt vouchers and share certificates. This will aid in proving, reconciling and controlling used and unused items. Number controls should be policed by a person who is detached from the particular operation. For example, accounting for consecutive numbers on checks should be done by a person who does not prepare and issue the checks. Unissued, prenumbered instruments that could be used to obtain funds should be maintained under dual control.

d. Current Records - Records should be posted daily to reflect each day's activities and to keep them separate and distinct from another day's work. The records should present the credit union's financial condition and structure as of the given date. Each account in the credit union's General Ledger must be individually proved and balanced at least monthly.

e. Subsidiary Control Accounts - Subsidiary records, such as share ledgers, loan ledgers and investment registers should be kept in balance with their General Ledger control accounts.

f. Audit Trail - The records and systems should be designed to enable the tracing of any given item as it passes through the credit union's books.

Some of the more prevalent recordkeeping deficiencies encountered during examinations include:

(i) General Ledger entries which fail to contain an adequate description of the transaction;

(ii) Lack of permanent and satisfactory records pertaining to cash items and overdrafts;

(iii) Tellers' cash sheets which do not contain adequate details;

(iv) Investment registers which fail to list all necessary information and date;

v) Reconcilement records of bank accounts which are not kept current and/or fail to reflect the description and disposition of outstanding items;

(vi) Inadequate details concerning debits and credits to the cash over and short account;

(vii) Use of erasures in correcting errors;

(viii) Failure to keep accounts and records posted on a current basis; and

(ix) Inadequate control of subsidiary records relating to lines of credit outstanding.

g. Audit - Every large credit union (over $5,000,000) should have an adequate audit program. Ideally, such a program would consist of a full-time, continuous program of internal audit and an annual outside audit by a firm of independent public accountants.

Of course, many credit unions may not be able to afford a full-time internal auditor. However, the supervisory committee can perform auditing procedures such as bank reconcilements, cash counts, review of officials' and employees' loans and review of expenses on a continuing basis.

Outside audits by independent accountants are highly desirable and should be encouraged. Most supervisory committees of large credit unions engage the services of a CPA because the operations are too complex and voluminous for them to effectively audit. All audits must meet the minimum standards contained in the Supervisory Committee Manual.

## 12.4 Recommendations

When making recommendations or criticisms of a credit union's internal control system, the examiner should consider the following points:

(1) The advantage and/or profitability of the suggestion to the credit union should be stressed, not the advantage to the examiner;

(2) The suggestion or criticism must have substance and merit. Criticism that might be regarded as petty or which reflects the personal preference of the examiner will not be well received;

(3) The recommendations or criticisms should be discussed with the appropriate operating personnel prior to bringing them to the attention of the board of directors. The record or procedure may have been devised for a specific reason and the credit union may have a persuasive reason for its continuance;

(4) Examiners will avoid recommending that forms or other supplies be purchased from a particular supplier. There is no reason why every credit union should have identical forms, records or systems;

(5) It is possible to overdo criticisms. Examiners should strive to correct major deficiencies before overwhelming officials with a volume of minor criticisms; and

(6) Best results are achieved when criticisms are based on specific findings, rather than generalities, and are accompanied by the recommended remedial action consistent with the seriousness of the deficiencies and the credit union's size and needs.

## 12.5 Conflict of Interest and Insider Dealings

The number of known cases of "insider dealings" and conflict of interest in federally-insured credit unions is very small as a percentage of all federally-insured credit unions, but, the aggregate cost of these cases to the NCUSIF has been severe, and the subject is, therefore, of serious concern.

While there are sufficient regulations in place to permit effective action against practices involving insider dealings and conflicts of interest, past experience has indicated that early detection is crucial. It not only minimizes potential losses but provides the opportunity to select among the many alternatives available to correct an individual problem. This is particularly so in cases where administrative action may be appropriate.

A survey was conducted in 1986 by the regional offices in an attempt to identify the incidence of insider dealings and conflict of interest. Although the largest problem area was loans to insiders, there were a number of other areas that were identified. Here is a summary of the survey results:

(a) Loans (to officials, employees, and affiliated persons)
- undercollateralized
- inflated appraisals
- preferential purposes
- preferential terms and conditions
- preferential rates

(b) Shares (to officials, employees, etc.)
- preferential rates
- interest free overdrafts
- failure to report dividends to IRS

(c) Conversion of Collateral
- repossesed land, autos, RV's, etc., sold at below market value

(d) Commissions or Fee Income
- E.g. - finder's fee, real estate, marketing fees
- commissions received by relatives or family business either from credit union or credit union members

(e) Ownership of Fixed Assets by Officials
- E.g. - building or computer
- typical case is where officials borrow from credit union to purchase asset and lease it back to the credit union

(f) Nepotism
- In some cases,
  - underqualified
  - overpaid
  - potential internal control problems

(g) Contract Abuses
- Salary of manager based on gross or net income or total assets

As the examiner works through each examination area, he or she should be alert to any potential insider dealings or conflict of interest problems. Since lending is the most common area of concern, a separate Guide section (8.5-2) discusses insider loans. Also, a standard workpaper, NCUA 2285, has been prepared, and should be utilized, for all insider loans. An examiner tailored workpaper on seven column paper should be prepared for any other analysis of insider dealings.

The supervisory examiner should be consulted and a record of action developed if a problem is recognized in this area. Appropriate action, such as administrative action, notifying surety, filing a bond claim, completing NCUA Form 2362, Criminal Referral Form, and notifying the FBI should be considered.

## 12.6 Workpapers and References

(1) Workpapers

- a. NCUA 2055, Examination Scope
- b. NCUA 2290, Lines of Credit-Credit Cards
- c. NCUA 2310, Collection Program

(2) References

- a. Accounting Manual for Federal Credit Unions

## 13. Supervisory Committee

The supervisory committee's audit is an important aspect of the annual examination. Although the audit is not part of the examination itself, the quality of the work can be a factor in the depth of examiner review. A quality audit can lead to examiner confidence in the records and thereby limit the extent of review required. Likewise a poor audit may necessitate expanding the examination scope. The completion of this examination step will be recorded on NCUA 2055, Examination Checklist. Toward this end, examiners will strongly encourage independent, professional audits in all credit unions to the extent it is economically feasible. A volunteer committee can be very useful for unannounced cash counts and follow up but seldom can perform an audit of the necessary depth to ensure that the items discussed as rating criteria are met.

The overall objectives of the examiner's review of the supervisory committee's annual audit and verification of members' accounts are to:

(1) Determine the scope of the audit, the controls that were used and the quality achieved;

(2) Ensure that minimum compliance with the requirements of the Act, Bylaws, Rules and Regulations and the Supervisory Committee Manual have been achieved;

(3) Investigate additional audit and members' account verification procedures used to accommodate the credit union's total operational activities, even though those audit and verification activities may not be specifically required by the Supervisory Committee Manual;

(4) Use the supervisory committee's verification of members' accounts and annual audit as aids in detecting problems present in the credit union;

(5) Initiate corrective action where weaknesses or exceptions are found in the annual audit and account verification; and

(6) Determine the extent of examiner work necessary to have confidence in the credit union's records.

### 13.1 Examination Procedures

The supervisory committee's most recent audit and verification will be reviewed. The examiner should determine whether the required members' account verification and annual audit procedures were performed and whether there was adequate documentation, in the form of schedules or workpapers, to support those procedures. The examiner will not usually need to check the accuracy of the audit.

### 13.2 Initial Meeting

The examiner should arrange an initial meeting with the chairperson of the supervisory committee during the early part of the examination. The supervisory committee chairperson should be contacted during this period to arrange for the initial meeting.

The purposes of this meeting are to:

(1) Obtain the members' account verification and annual audit workpapers;

(2) Obtain other workpapers and minutes of the supervisory committee's activities prepared since the previous examination;

(3) Learn of credit union or supervisory committee programs introduced since the previous examination;

(4) Provide the examiner an opportunity to appraise the qualifications and abilities of the supervisory committee;

(5) Enable the examiner to determine the extent of the committee's familiarity with the credit union's operations, management and the status of the credit union's financial condition; and

(6) Enable the examiner to determine the selection procedure for the credit union's auditors.

### 13.3 Workpaper Access

When the supervisory committee performs the members' account verification and/or the annual audit, the examiner will generally have little or no difficulty in obtaining access to the supporting workpapers. The workpapers may not be as available when the supervisory committee directs an independent auditor to complete some or all of the work.

Review of the audit firm's workpapers may require significant time and travel when other than a local audit firm is used. In such instances review of the actual workpapers may be performed by another examiner. Such arrangements should be made through the Supervisory Examiner. In rare instances where review of audit workpapers cannot be accomplished in a timely manner, the workpaper review may be omitted; generally, however, review of workpapers will be omitted only when the audit firm has a reputation for performing quality audits. As a minimum, the examiner will review the outside auditors engagement letter and/or management letter and the audit report submitted to the Supervisory Committee.

The auditor's workpapers include all the evidence gathered to show work done, the methods and procedures followed and the conclusions reached. The auditor's workpapers are confidential and cannot be made available to a third party without consent of the client. Therefore, the auditor may not want to release the workpapers to the examiner. The examiner should not take any exception to this practice; the workpapers are the auditor's personal property.

When this situation occurs, the auditor will usually ask the examiner to visit an office where the workpapers will be available. The auditor may also require that an employee be present during the examiner's review, a not uncommon request. The review should be conducted in the same manner as any other. The examiner's comments should be reserved until the review has been completed and an overall picture of the work's adequacy and accuracy has been developed. When the review is completed, the examiner will go over the findings with the auditor and with the supervisory committee.

There may be a few instances where the independent auditor refuses to allow the examiner access to the workpapers. If that happens, the examiner will contact the supervisory committee chairperson to request aid in getting the workpapers. Part 701.12 of the Rules and Regulations requires that the examiner be allowed access to audit workpapers. If the auditor still refuses, the supervisory committee should be told that the applicable work is unacceptable. An annual audit or verification found unacceptable for these reasons should be redone.

### 13.4 Standards

Certain standards must be used in performing the review of supervisory committee work. The Supervisory Committee Guide discusses the scope of the audit and verification that should be performed. In some cases minimum audit procedures will be inadequate because of the services or circumstances in a particular credit union. It may be necessary to expand procedures in "high risk areas" such as cash operations, special service areas such as share drafts/ATMs or when a credit union is experiencing recordkeeping problems. Audit procedures may also be expanded in areas where there is unusual activity or volume or where there are recently added programs or requirements. For instance, unusual activity might be a credit union that has excessive amounts charged to officers' and directors' travel expenses for a specific period; unusual volume might be a credit union with a 30 percent loan to share ratio with the remainder of the assets invested. The first case might require an expansion of the expense review; the second case might require an expansion of the investment review. Regulations regarding transaction account reserves and the volatility in the money market should lead auditors to expand their review of the credit union's liquidity position and capital structure.

As part of the review of the audit, the examiner should determine if the completed audit procedures (those not supported by standard audit forms) were properly documented by workpapers included in the audit or verification report. The Supervisory Committee Guide instructs the committee to maintain adequate workpapers to support its audits. Since standard workpapers cannot be provided for every situation, the committee or auditor will need to prepare special workpapers that will best serve the purpose for which they are intended. The workpapers should:

(1) Coordinate and organize all phases of the audit;

(2) Facilitate preparation of the final audit report; and

(3) Substantiate in detail the opinions and findings in the report.

### 13.5 Auditors

A meeting may be necessary with the person or firm hired by the supervisory committee. The meeting will serve as a fact gathering opportunity that will assist the examiner in determining whether there were additional audit steps used and if so, how they were used. Examiner objectivity and independence must be maintained. Adverse comments should be reserved for the final meeting with the committee. The examiner should explain any audit deficiencies to the auditor and provide an opportunity for the auditor to comment. If there is agreement, the examiner should determine when corrections will be made. Whether the auditor is in agreement or not, the examiner will discuss all major audit findings with the supervisory committee and in the examination report.

A final meeting may be needed to confidentially review the examiner's findings and observations regarding the audit and/or verification work since the previous examination. A final meeting should only be held if the examiner has material audit or verification deficiencies to discuss with the committee. Specific agreements should be reached with the supervisory committee to correct deficiencies during the next audit or verification or within a reasonable period of time. The chairperson and/or whole committee should be invited to the joint conference or exit interview.

## 13.6 Rating Criteria

An audit is the critical and systematic examination of the internal controls, statements, records and accounting transactions prepared by management and the other financial and legal records. An acceptable audit is that which satisfies the requirements of the particular case when judged by professional standards of performance.

An unacceptable audit is one that does not meet the requirements stated above. It is not possible to define exact acceptability standards for all audits performed in all credit unions; examiners must use their own professional judgement in each case to determine if an audit fulfilled the requirements in a particular credit union.

An audit or verification will be considered unacceptable and plans of action will be developed to have all or parts of the work redone when the examiner determines that:

(1) Material parts of the audit were not done;

(2) Material parts of the audit cannot be supported by workpapers; and/or

(3) Material areas of credit union operations were left unaudited.

## 13.7 Workpapers and References

(1) Workpapers

- a. NCUA 2055, Examination Scope

(2) References

- a. Federal Credit Union Act
  1. 111 - Compensation
  2. 115 - Supervisory Committee
- b. Federal Credit Union Bylaws
  1. Article V - Meetings of Members
  2. Article X - Supervisory Committee
- c. NCUA Rules and Regulations
  1. 701.12 - Supervisory Committee Audit
- d. Supervisory Committee Guide

9

## 14. Electronic Data Processing

Credit unions have become increasingly reliant upon computerized recordkeeping. The nature and complexity of electronic data processing (EDP) increases the potential risk exposure from disaster, error or fraud within the credit union or service corporation. Although there are no changes in the fundamental concepts of internal control when reviewing computerized systems, there necessarily will be some changes required in techniques and approach.

The examiner's primary responsibility in the area of computerized recordkeeping is to be alert to the credit union's procedures and internal controls which minimize the exposure to loss. Conditions may exist which could prompt a more in-depth analysis. These conditions could include:

(1) Records prepared by the computer that are materially out of balance;

(2) Large unidentified or non-clearing amounts in the Unapplied Data Processing Exceptions accounts;

(3) Conversion to a new data processing system or expansion of an existing system since the previous examination;

(4) Significant evidence of inefficiency (e.g. slow daily balancing, delayed closing of books, delayed distribution of members' statements, weak physical or internal controls, etc.); and

(5) Significant adverse EDP comments raised during the supervisory committee audit.

If it appears that material deficiencies exist in management's policies and internal controls, or in the procedures to implement these policies or internal controls, the deficiencies should be documented and reported to the Regional Office for a decision as to further action which may be needed. It is not intended that the examiner will function as an EDP Specialist. This section is designed to provide general information about EDP operations.

Occasionally the examiner is asked to express an opinion concerning some specific EDP hardware or software system for use in a specific situation. While the examiner may point to certain desirable features that the credit union officials should look for before purchasing, leasing or contracting to have their records processed on such equipment, a particular make, model or system should never be recommended. Credit unions which are purchasing accounting services must be in compliance with the NCUA Rules and Regulations, Section 701.26, Credit Union Service Contracts.

## 14.1 Definitions

An EDP operation is defined as the use of a computer for the accumulation, maintenance and dissemination of financial data and records. An EDP system includes the central processing unit, attached peripheral equipment, telecommunications equipment, remote terminals, the physical facilities housing the computer equipment and the storage areas for file media and supplies. An EDP system must be capable of storing program instructions internally and locating and controlling access to internally stored data.

An EDP system does not include the general line of posting and accounting machines which have the capability of temporarily storing data. Machines or systems from which information can be retrieved by means external to the machine (including magnetic strip ledger cards) should not be classified as EDP systems.

EDP operations in use by credit unions can be classified into two broad categories based on the physical location of the computer and the degree of credit union management control over the day-to-day operation of the computer system:

(1) In-house processing covers those cases in which the computer is located on the credit union premises and the credit union management has direct responsibility for the day-to-day operation of the computer. In-house processing can be further divided into two classes based on the degree of credit union involvement in the programming, system design and program maintenance efforts required in an on-going EDP operation:

a. Turn-key systems are in-house processing systems for which the individual credit union has no direct responsibility for programming, system design or program maintenance. Turn-key systems are supplied with both the hardware and software necessary to process the desired applications. The credit union's involvement is limited to providing adequate space and personnel to operate the computer equipment. Initial programming and continuing support is provided by an outside party. The vendor supplying the turn-key system should also provide training for credit union staff who will be using the automated applications or operating the computer hardware.

b. User programmed systems are in-house processing systems for which the individual credit union retains the responsibility for programming, system design or program maintenance. The initial software for a user programmed system may be purchased; however, it will generally be modified to some degree to meet the specific needs of the credit union. The hardware may be purchased from the same source as the software or it may be purchased from an independent source; in any event the software and hardware purchases (or leases) should be identifiable as two separate transactions.

The responsibility for the programming effort is the primary distinguishing feature between turn-key and user programmed data processing systems.

(2) Outside processing refers to those instances in which the computer is located away from the credit union premises and the management responsibility for the operation of the computer rests with an outside party. Outside processing can be obtained from several sources, including:

a. Another financial institution,

b. A credit union service corporation,

c. An independent data processing service company, or

d. The credit union's sponsor.

Regardless of the source of the processing the distinguishing characteristics of outside processing are the physical separation from the credit union's operations and the absence of direct management responsibility for the computer operation.

There are two basic processing modes that can be used with either type of EDP operation:

(1) Remote processing, in which the data processing source documents or input (member transactions, file changes, etc.) are physically transported to the data center for processing; and

(2) On-line processing, in which the input transactions are entered through a computer terminal located at the credit union and then electronically transmitted to the data processing center.

Either of the two processing modes can use batch processing, in which individual transactions or input data are accumulated for a period of time, generally daily or weekly, and then are delivered or transmitted to the data center as one group or batch of work. Real-time processing provides for immediate interaction between the user and the computer through an on-line terminal. With this type of processing the computer based files can be accessed and updated as the transactions occur. Real-time processing can only be used in the on-line processing mode.

## 14.2 User Controls

The user control procedures discussed in this section apply to those credit unions using outside processing and to those using in-house processing systems. In either case the operations and related controls provided by the user should be separate from the EDP operation. The user controls place the emphasis on the evaluation of EDP services and related internal controls from a user's standpoint. NCUA 2480, EDP User Control, is a checklist workpaper which may be used to document the examiner's review and the credit union's deficiencies.

### 14.2-1 Management Controls

The following description of EDP planning and steering committee functions is meant to apply to a wide variety of situations. In small credit unions the number of people and the division of duties will not be possible; however, the functions are still valid and should be performed. In a one-person credit union many of the functions may have to be performed by the supervisory committee or the board of directors. In all cases the examiner should review the functions being performed and should not be overly concerned with titles or committee names.

The overall objectives of the data processing function can best be realized through a planning process which addresses the needs of the credit union. The planning process should encourage the coordination of all concerned groups. For example, decisions to automate or upgrade existing applications should be based upon the needs of the entire organization, as opposed to those of one or two influential persons (i.e., the data processing manager and/or the head of a major user group). The written plan, including long and short term objectives, should be reviewed and updated periodically by senior management and approved by the board of directors. Implementation of the plan requires supervision and direction from senior management. This may be accomplished within the framework of written policies and procedures. A review of the planning process and management's progress in achieving its defined objectives for the data processing function can aid in evaluating management and the data center.

The EDP planning process can be instituted properly by a management group, such as a steering committee. This committee should establish the objectives of the data processing function and a 3- to 5-year timetable for their implementation. The committee should not become directly involved with routine daily operations of the data center. Duties and responsibilities of the committee should be clearly defined in a formal policy and include the review and approval of:

(1) Major changes in hardware or software;

(2) Research and development projects under study;

(3) The results of any cost benefit analysis;

(4) Software application development or acquisition;

(5) Project priorities;

(6) Resource allocation in terms of time, personnel and equipment;

(7) Controls in effect;

(8) Conversion plans;

(9) Emergency procedures, contingency and physical security plans;

(10) Insurance coverages in effect; and

(11) Budgets and plans pertaining to the data processing function.

To effectively coordinate and monitor the automation efforts among EDP user departments and audit groups, the committee should receive information from all the areas concerned with data processing, including the audit department. Committee members should include representatives from those major areas and may also include representatives from administration and operations. Members do not have to be department heads but should be knowledgeable about department policies, practices and procedures. Additionally, each member should have the authority to make decisions within the group for their respective functions. The auditor may be a voting member of the committee or may act as a consultant on audit and internal control. The steering committee should also monitor performance via management reports and institute appropriate action to achieve the desired results.

Formal minutes of the EDP steering committee should be maintained, not only as a record of the proceedings and decisions, but also to inform the board of data processing activities. The minutes should reveal whether the committee is fulfilling its responsibilities.

External factors often influence the planning process. Social forces within the local trade area can have a bearing on the use of data processing resources. Legal, regulatory and competitive factors must also be considered. In essence, the planning should be structured to enable the data processing to perform within its environment.

### 14.2-2 Operational Controls

When data processing services are provided by an external servicer, many of the credit union's controls are displaced to the servicer. Generally, these controls are similar to those found in a manual system and only appear different because the environment may be unfamiliar. Following are brief descriptions of basic operational controls that should be found in a serviced environment. Similar controls also apply to user departments that have work processed by a separate EDP department within their own credit union.

(1) Separation of Duties - A basic control used in any internal control system is separation of duties. This control requires collusion for any improper activities to take place. Therefore, no one person should be able to initially authorize and execute a complete transaction. Servicer personnel should not initiate transactions or correct data except when such activity may be required to complete processing in a reasonable period of time. If this unusual situation arises, transactions should be approved by appropriate levels of management at the data center and at the credit union. Documented approvals, together with details of the cirumstances that required this activity, should be maintained at the data center and at the credit union.

Input and output duties normally should not be performed by the same person. In some instances, staff limitations may cause one person to be responsible for several activities. Included among these concentrated activities are:

a. Preparing batches and blocks or other input for entry to the system or shipment to the servicer;

b. Operating data entry equipment, or data conversion devices;

c. Preparing rejects and nonreads for re-entry into the system;

d. Reconciling output to input or balancing the system;

e. Distributing output to ultimate users; and

f. Posting the General Ledger and balancing computer output to the General Ledger.

(2) Rotation of Duties - Internal control may be improved through rotation of assignments and periodic absences. This will prevent one person from having total command over any one job for an extended period of time and will provide cross-training and backup personnel. Personnel should be required to take uninterrupted vacations to allow pending transactions to clear. The absences are most effective if they extend over the end of an accounting period for two consecutive weeks.

The requirement of job rotation can be greatly facilitated through the use of a policy and procedures manual as a training and reference document. Manuals for each application normally consist of a user's guide provided by the servicer which is supplemented by procedures written by the user. Manuals normally delineate preparation and control of source documents, and certain practices pertaining to: control over the movement of documents from the user to the servicer and their return; the daily reconcilement of totals to General Ledger; and changes to master files.

(3) Dual Control - Dual control in automated systems should be used in the same manner as in a manual system. Supervisory holds should be placed on member accounts that require special attention. For example, dormant accounts, collateral accounts and accounts with large uncollected funds balances normally have holds that require the action of two people to remove. In addition, certain types of transactions (e.g., master file changes) should require special codes or terminal keys from two people before they can be completed. When a hold on an account is added or removed or when a transaction requiring supervisory approval is completed, exception reports should be printed and reviewed by a designated person not involved with the transaction. Used conscientiously, automated dual control methods can be superior to manual procedures.

### 14.2-3 Internal Controls

Internal controls fall into three general categories:

(1) Administrative controls are usually established from management review of daily operations and output reports. Each application includes certain basic controls and exception reports that are common to all credit union operations. Exception reports and controls must be properly used to be effective, especially methods for controlling dormant accounts, kiting, drawings against uncollected funds, overdrafts, and posting of computer-generated income and expense entries.

(2) Dollar controls ensure that all authorized transactions have been processed. Work should be proven and control totals established prior to forwarding the records to the data processor. Balancing procedures should be complete and trial balances must be reconciled to input, to control sheets and to the General Ledger. Report distribution should follow a formal procedure. All rejects must be accounted for, corrected and resubmitted, and all exception reports should receive proper supervisory attention.

(3) Non-dollar control totals are used when dollar values are not present, as in name and address changes. These controls should be established prior to forwarding for processing and be adequately reviewed to ensure that all non-dollar transactions have been processed. For example, new account reports should be checked against new account input forms to assure that data has been properly entered. To protect data integrity, procedures should be developed to control master file and program changes. The credit union should verify that only its authorized changes are used to alter data, and that data center employees do not initiate master file changes.

### 14.2-4 Data Communications

The concept of data communications transfers the responsibility for some internal controls to the user credit union or department. Internal controls of a data communications system should be reviewed to determine their use. Because many of the controls reside in software routines and in hardware devices, on-line controls, although similar, are less visible than those in a batch system.

The controls available to the user can be generally categorized into four areas:

(1) User Identification - This control allows only authorized personnel to use the system and provides for personal and terminal identification for each transaction entered. Users may be identified by key, machine-readable badge, password or identification number. When terminals are equipped with key or card-type locks, strict control of keys and cards is necessary to protect the system. Other systems use software controls which require password or identification numbers to gain access to the system. Security procedures should strictly control access to those user identifications, and passwords or numbers should be changed on a periodic or random basis. Some terminals can be controlled through restricting access to the terminal area by placing them in a remote or locked area, or by establishing definite times for terminal activity.

When a terminal is not hard-wired or permanently connected to the host computer (i.e., a dial-up terminal), special manual and automated controls must be established to ensure proper host/terminal relationships. Protocol may be established by manual procedures that require data center personnel to call back the terminal operator to ensure that the proper terminal has keyed into the computer. Automated methods may include software checks on hard-wired terminal identification numbers or a dialogue between the data communications software and the intelligent terminals. Use of devices with variable keys may provide additional assurance that proper host/terminal relationships are maintained.

(2) Level of Accessibility - Another basic control is to allow each user to access only that information needed in the performance of that person's duties. Separation of duties when using data communications system should be evaluated with the same criteria as a manual system; that is, one person should not be able to make all transactions relating to a given event. For example, when a loan is charged off, one person should not control adjustments to both the Individual Loan Ledger and the General Ledger without appropriate compensating controls.

(3) Restricted Transactions - Restricted transactions are specialized transactions that should only be used by supervisory or management personnel. Examples are: reversing transactions, dollar adjustments to customer accounts or daily balancing transactions. Management should frequently review user needs and the appropriateness of accessibility.

(4) Activity and Exception Reports - Report output will vary depending upon the sophistication of the data communication software. At a minimum, reports should be generated that detail transactions by terminal, operator and type. More sophisticated software will produce such reports as the number of inquiries by terminal, unsuccessful attempts to access the system, unauthorized use of restricted information and any unusual activity such as infrequently used transactions.

Activity reports monitor system usage and may not be printed daily. However, they should be summarized and reviewed periodically by management to ensure efficient machine utilization. Exception reports must be produced daily and require daily review by designated personnel who have no conflicting responsibilities.

As the sophistication of a communication system increases, the complexity of various controls will also increase. Generally, communication systems fall into three basic levels: inquiry only, memo-post, and on-line post. However, there can be infinite combinations and variations of these levels of systems, as follows:

(1) Inquiring only system - This system gives the user the ability to search and review machine-readable records, but does not allow for altering those records. The level of control and security to this system is low and a major concern is the access to confidential information.

(2) Memo-post - This level is more sophisticated and allows the user to temporarily update records. Permanent posting is applied through the batch processing at the servicer. Memo-post systems should be controlled through limiting physical access and restricting certain transactions to supervisory personnel.

(3) On-line post - This system, sometimes called a real-time system, requires the strictest controls because all accepted transactions entered through the communication system are permanently applied to the machine-readable records. Besides controlling access, the reports produced by the system should provide all activity and exception information and should be reviewed by appropriate levels of management.

## 14.2-5 Backup

Data communication systems are susceptible to software, hardware and transmission line problems which may make them unusable for extended periods of time. If the credit union depends on its data communication system for its daily operations, appropriate backup provisions are necessary. Backup is the ability to continue processing applications in the event of failure of the data communication system. Normally, backup will be provided by a batch processing system or by "intelligent" terminals (programmable) that can operate in an off-line mode. Regardless of the method used, a comprehensive backup plan with detailed procedures is required. When using a batch backup system, data must be converted to a machine-readable format and transported to the servicer. This process may require additional personnel (e.g., key punch operators and messengers) and equipment. Therefore, detailed procedures on how to obtain and use the personnel and equipment must be included in the plan. Because of the evolutionary nature of on-line systems, a batch backup may not remain compatible. Periodic tests of batch or other backup capabilities should be performed to ensure that protection is available and that employees are familiar with the plan.

## 14.3 Audit

The effectiveness of the audit review over work processed by the servicer must be determined. The following factors should be considered, as applicable:

(1) Whether or not it would be practical for the credit union to have an auditor;

(2) The training and background of the credit union's outside auditors;

(3) Audit functions performed by the credit union's outside auditors, by the servicer and by supervisory personnel; and

(4) EDP audit techniques presently being followed.

Many "around-the-computer" audit techniques are available and should be performed periodically by designated personnel at the credit union. Examples include:

(1) Developing data controls (proof totals, batch totals, document counts, number of accounts and prenumbered documents) at the credit union prior to submission to the servicer. The auditor should sample the controls periodically to ensure their accuracy;

(2) Spot-checking reconcilement procedures to ensure output totals agree with input totals, less any rejects;

(3) Sampling of disposition of rejected, unpostable, holdover, and suspense items to determine why they are unprocessable and to assure they are properly corrected and re-entered on a timely basis;

(4) Verifying selected master file information and the review of exception reports, such as service charge codes and loan extensions to source documents;

(5) Spot-checking of computer calculations, such as loan rebates, interest on deposits, late charges, service charges and past-due loans, to ensure that the calculations are being made properly;

(6) Tracing of transactions to final disposition to ensure that there are adequate audit trails;

(7) Reviewing source documents to ensure that sensitive master file change requests have the required supervisory approval;

(8) Visiting the servicer periodically;

(9) Reviewing the processing procedures and controls; and

(10) Relying on other audits of the servicer.

In addition, "through the computer" audit techniques allow the auditor to use the computer to check processing steps. More frequent use is being made of audit software programs to test extensions, footings, etc., as well as to prepare verification statements. If a credit union has audit software, provisions should be made with the servicer to allow its use.

Regardless of whether the data processing is done internally or through an outside servicer, the board of directors of a credit union must provide an adequate audit program for all automated records. If the credit union has no internal EDP audit expertise, the non-technical "around the computer" methods can provide minimum coverage. This should be supplemented by comprehensive outside EDP audits.

## 14.4 Records

Adequate record protection for a credit union receiving services can be accomplished relatively inexpensively by:

(1) Relying upon a servicer to provide backup for records if:

   a. The servicer formally agrees to it;

   b. The credit union can furnish an examiner or auditor with evidence of what records are retained by the servicer and for how long; and

   c. The servicer is located sufficiently distant from the credit union.

   The credit union should also review the backup procedures for data files, program files, documentation and equipment at the servicer. Should the data center become inoperative, those backup procedures would be necessary to continue processing the credit union's work.

(2) Microfilming all items that leave the user prior to being sent to the processor. This protects the credit union in case any items are lost, misplaced or destroyed. In addition, most transit insurance requires microfilming for the coverage to be in force.

(3) Assuring that all vital records have been backed up, whether the credit union can rely upon its servicer to provide such off-premises backup.

In the event of a major disaster, computer facilities may not be available even if the servicer has duplicated the records on machine-readable media. Therefore, a form of remote storage of records which can be manually processed must be maintained. Many credit unions today have a sufficient volume of items to justify the cost of microfilming and several vital records storage firms have emerged to meet the need for adequate remote storage at reasonable cost. Such firms can assist in developing a comprehensive microfilm-based record protection program, or user management may wish to devise its own plan.

### 14.5 Contracts

A written contract must specify responsibilities of both parties whenever a credit union is receiving EDP services from or providing EDP services to another corporate entity. If automated services are received without a valid contract, the credit union's extended fidelity coverage over the servicer's personnel is usually void. The provisions often contained in an EDP service contract include:

(1) Specific work to be performed by the servicer and the frequency and general contents of the related reports;

(2) The basis of costs, including development, conversion and processing, and additional charges for special requests;

(3) Established time schedules for receipt and delivery of work;

(4) Audit responsibility, including the right of user representatives to perform audit procedures;

(5) Backup and record protection provisions (equipment, program and data files) to ensure timely processing by the service center in emergencies;

(6) Establishment of liability for source documents while in transit to and from the service center. If the service center is responsible, the servicer should have adequate insurance coverage for such liabilities;

(7) Maintenance of adequate insurance for data losses from error and omissions;

(8) Confidential treatment of records;

(9) Ownership of computer programs and related documentation;

(10) Ownership of master and transaction data files and their return in machine-readable format upon the termination of the contract or agreement;

(11) Price changes, cost and method of cancellation of the contract, or withdrawal from the servicing arrangement by either party, including adequate time allowance;

(12) Notification from the service center to the users of all systems changes that would affect procedures, reports, etc.; and

(13) Financial information to be provided periodically (preferably annually) by the servicer to credit unions.

These guidelines are designed to adequately protect the credit union and the service center and, as such, any exceptions noted should be discussed fully with management.

### 14.6 References

(1) NCUA Rules and Regulations

  a. 701.26 - Credit Union Service Contracts

(2) Accounting Manual for Federal Credit Unions

## 15. Regulation Compliance

During each examination, examiners will review the credit union's compliance with regulations promulaged by NCUA and other agencies. Examiner responsibility for consumer regulation is discussed in subsection 15.11. Examiners will also check the fees paid to, and the financial reports filed with, NCUA. The examiner's objectives in the regulation compliance review are to determine that:

(1) Required reports are being filed on time;

(2) Contents of reports are materially accurate;

(3) The credit union is adequately protected; and,

(4) Corrective action is initiated when practices, policies, or procedures are deficient or when violations of law, regulations, or requirements are noted.

### 15.1 Charter and Bylaws

The credit union's official copy of the charter and the bylaws is an important document that should be updated by officials on an on-going basis. The document is considered a vital record and should be adequately protected.

The charter sets forth the field of membership and the territory of operation. Examiners need to be aware of the field of membership and that only those named in the charter are being accepted as members.

Each credit union operates under a standard set of bylaws. Over time, standard changes to the bylaws have been issued by NCUA. Most of these changes have been or should have been approved by the officials and placed with the bylaws. Further, specific bylaw amendments have been approved on a case-by-case basis and should also be on file.

### 15.2 Security Devices

Part 748 of the NCUA Rules and Regulations and Section 5193 of the Accounting Manual for Federal Credit unions establish minimum standards and procedures with which credit unions must comply. Examiners should determine that credit unions have established adequate security programs for their principal offices and for their branch offices in accordance with the regulation. Branch offices are included because all locations need some measure of security protection.

Management is responsible for providing adequate safeguards against robbery and burglary. Security procedures should discourage robberies, burglaries and non-employee larcenies and should assist in the identification and the apprehension of those who commit such crimes. Provisions of the security program, including periodic training of all employees, should be carefully followed.

The examiner needs to determine that management is aware of its responsibilities in this area. A deficiency in the program or inadequate employee training could easily nullify the most comprehensive and detailed security program. Additionally, a credit union that becomes careless in the areas of maintenance may find that its security devices are non-operative or ineffective simply because equipment is not periodically tested.

The examiner must remember that this part of the regulation is flexible and that the needs, circumstances, and capability of the credit union must be taken into consideration.

Exceptions should be dealt with in the Examiner's Findings or in the Record of Action section of the report, depending on the severity.

If the credit union's office is relocated, or major modifications are made in the security program, appropriate changes should be reflected in the program description. Moreover, the program should reveal reasons for major deviations from basic requirements.

During each examination, the examiner will review the annual Report of Officials, NCUA 4501, to determine whether the Statement of Compliance has been signed by the chief executive officer or the security officer.

### 15.3 Records Preservation

Part 749 of the NCUA Rules and Regulations and Section 5190 of the Accounting Manual establish the minimum requirements with which credit unions must comply in a records preservation program. It requires off-site storage of duplicate vital records which can be used for reconstruction purposes in the event of a catastrophe.

### 15.4 Currency and Foreign Transactions

The Financial Recordkeeping and Currency and Foreign Transactions Reporting Act (CFT) was passed by Congress in an effort to keep track of large currency transactions through the nation's financial system. The purpose of the Act was to curtail the concealment of funds obtained illegally and then laundered through financial institutions and brokerage houses.

The regulation generally requires credit unions to identify their members by social security or taxpayer identification number, to retain records of all currency transactions over $10,000, and to identify all foreign (into and out of the U.S.) transactions over $10,000. Specific reporting requirements and timeframes for these types of transactions are outlined in the regulation.

Management needs to be aware of its responsibilities in this area. Although there are many possible minor violations of the regulations, examiners should be most alert for "laundering," the practice of exchanging thousands of dollars in small bills for large, "clean" bills that can be more easily transported out of the country. Financial institutions sometimes participate in the laundering, without reporting the transaction, for a percentage of the money exchanged. For example, $20,000 in small bills might be exchanged for $19,000 in large bills, with the remaining 5 percent being the institution's. The examiner should be alert to employee and/or official fraud in these types of transactions.

Compliance has taken on greater importance due to the failure of many financial institutions to follow the reporting requirements of the Regulation. Therefore, during each examination, the examiner will inform the manager/treasurer of the credit union of the regulation and instruct him/her to complete the form NCUA 2435, Currency and Foreign Transactions Letter. The letter will be returned to the examiner, completed and signed by the treasurer/manager, for inclusion in the examination report. When appropriate, similar questions should also be posed to the credit union's teller operations to determine if procedures are in place to detect such transactions.

If a serious violation of the regulation is noted, the examiner should notify his/her Supervisory Examiner immediately who will notify the Regional Office. Further instructions will then be given to the examiner. Infrequent and unintentional violations of the Act should be reported in the Examiner's Findings and/or the Record of Action with agreements reached to correct the procedural deficiencies.

### 15.5 Share Insurance

During each examination, the examiner will determine the accuracy and the payment of the share insurance premium (if applicable) and the capitalization deposit. The credit union's year-end report should be checked for accuracy with the total shares reported on the annual share insurance invoice. If the premium and/or capitalization deposit was either over or underpaid, the examiner should submit the form NCUA 2460 (revised 11/85) to correct the inaccuracy. Refunds are made by the Treasury Department, thus, it may take several weeks for the credit union to receive a check. Procedures for processing capitalization deposits and operating fees for the various new charter, conversion, and merger situations are addressed in periodically updated instructions from the Controller's Office, NCUA, Washington, DC. Current instructions for the wire transfer of funds will also be provided through the Controller's Office.

### 15.6 Operating Fees

Section 105 of the Act requires that each Federal credit union in business as of January 1 pay an operating fee. Newly chartered credit unions pay no fee until January 31 of the year following the first full calendar year after the date chartered. Example: A credit union chartered on May 15, 19X1, would pay its first operating fee on January 31, 19X3.

Merging credit unions and credit unions converting to State charters will not receive a refund. The examiner will determine that assets were reported accurately and that the fee was correctly paid. Over/under payments should be handled as discussed in the previous subsection and NCUA 2055, Examination Checklist, will reflect completion of this procedure.

### 15.7 CLF Stock Subscriptions

Refer to section 3 of the Examination Chapter for instructions pertaining to the audit of the CLF Stock Subscription if the credit union is a direct member of the CLF.

### 15.8 Transaction Account Reserves

The Board of Governors of the Federal Reserve System promulgated Regulation D, Reserve Requirements of Depository Institutions, to implement the Monetary Control Act of 1980. The Regulation requires credit unions and certain other depository institutions to maintain a cash reserve against deposits in transaction accounts. Transaction accounts, as defined by the Act, include: share drafts, demand deposits, NOW accounts, automatic transfer accounts, and certain other accounts permitting telephone or similar transfers to third parties.

The enforcement authority for Regulation D lies with the Federal Reserve Board. Therefore, credit unions should contact their local Federal Reserve Bank to determine reporting and reserve requirements to avoid penalties.

### 15.9 Margin Securities

When loans are secured by margin securities, Federal credit unions are subject to the provisions of Regulation G, "Securities Credit by Persons Other Than Banks, Brokers or Dealers," and the credit union members are subject to the provisions of Regulation X, "Rules Governing Borrowers Who Obtain Securities Credit," issued by the Federal Reserve Board. The purpose of these regulations is to help curb excessive credit in the securities market. Regulation G generally applies to the lender, whereas Regulation X requires that the borrower must comply with the margin regulations to which the lender is subject.

Regulation G stipulates, in part, that any credit union which extends credit of $200,000 or more during a quarter (or has total credit outstanding at any time during the quarter of $500,000 or more), which is secured directly or indirectly, in whole or in part, by collateral that includes any margin security (regardless of the purpose of such loans), must register by filing FR G-1 with the District Federal Reserve Bank. Margin securities are defined in section 207.2(d) of Regulation G.

All registrants must file FR G-4 on an annual basis as prescribed by the regulation.

Margin requirements are placed in effect for loans made by credit unions subject to registration and for the purchase or the carrying of margin securities (purpose loans) when such margin securities collateralize the loan. As margin requirements are changed, the Federal Reserve Board issues appropriate supplements to the regulations.

If the credit union did not register with the Federal Reserve Bank because its margin security collateral loans did not exceed the amount specified in the regulation but was subsequently required to register for having granted the stipulated amount of such loans within a quarter, or carried at the end of a quarter, the loans granted prior to the credit union's becoming subject to registration will not have been made subject to the margin requirements.

A credit union currently registered which has not extended any credit secured by margin securities during any 6-month period and which does not have more than $200,000 of such credit outstanding during that period, will become eligible for deregistration. FR G-2 (Deregistration Request) is used for this purpose. If a credit union has applied for and received notification of deregistration during the period of the examination, the examiner should determine that the credit union was eligible for deregistration.

Purpose Statement, FR G-3, must be executed on all loans secured by margin securities extended after the credit union becomes subject to the registration requirements. The statement is designed to prevent borrowers from obtaining funds for the purchase of margin securities on the basis of presenting a false purpose statement. The lender is required to countersign FR G-3 after accepting the borrower's purpose statement. If desired, FR G-3 can be used by credit unions in place of the regular loan application on loans secured by margin securities. Approval by either the credit committee or the loan officer can be noted on this form or on an attachment. The credit union will, of course, need to have sufficient financial information on file to support the granting of the loan. The examiner should determine that, in the case of credit obtained from an overseas office of a credit union, both the credit union and the borrower are aware of the requirements of FR X-1.

The examiner should determine that the credit union has registered under the regulation by having executed FR G-1 if it was required to do so and should make a reasonable determination that annual reporting is accurate. This can usually be accomplished through the sampling technique followed during the loan analysis. However, in many of the larger credit unions, it will be possible to conduct a more reliable review. For example, if a collateral register is maintained, all loans secured by margin securities could be easily pinpointed. Also, certain data processing systems may provide output records that will facilitate the examiner's analysis. If violations are noted, agreements for correction should be obtained.

### 15.10 Political Contributions

The Federal Election Campaign Act prohibits federally chartered corporations (including Federal credit unions) from contributing to political campaigns. However, the Federal Election Commission Rules and Regulations permit a trade association to solicit from a credit union's members if:

(1) The credit union has separately and specifically approved the solicitation; and,

(2) The credit union has not approved a solicitation by any other trade association during the calendar year.

If the conditions above are met, a credit union can disseminate to its members trade association prepared information that solicits campaign funds for that trade association.

Further, Federal credit unions may not make share withdrawals for members who authorize payments to a third party as political contributions. Doing so would constitute a donation of time and resources by the credit union and is prohibited.

### 15.11 Consumer Laws and Regulations

During the late 1960s and the 1970s, Congress passed a number of laws intended to provide certain rights and remedies to consumers. This body of laws and its implementing regulations are generally known as "Consumer Laws and Regulations." This includes such laws and regulations as Truth-in-Lending (Regulation Z), Equal Credit Opportunity (Regulation B), Electronic Fund Transfers (Regulation E), etc.

NCUA is charged by Congress to enforce these laws and regulations in Federal credit unions and, in certain instances, state credit unions. Additionally, NCUA is required to provide annual written reports to the Federal Reserve Board for Congressional reporting purposes, documenting NCUA's enforcement efforts, the credit unions' level of compliance, and other information. Furthermore, various public interest groups, as well as the other regulatory agencies, take a keen interest in interagency enforcement programs. As such, NCUA's consumer enforcement continues to be an important area with regard to the public and the regulatory sectors.

The procedures set forth below are intended to accomplish both NCUA's Congressional mandate to enforce consumer laws and regulations and to furnish the required reports to Congress. NCUA's enforcement of the laws also serves to limit a credit union's exposure to civil and criminal liability.

### 15.11-1 General Guidance

The examiner will address only those areas which are considered substantive and for which interpretations are clear. The examiner will not review forms for technical compliance but only for assurance that they were properly completed.

The compliance review will be made in conjunction with other examination procedures. For example, a special loan profile should not be selected for compliance review. Only those loans which are being reviewed for other examination purposes should be reviewed for compliance. Violations and corrective action agreements should be recorded in the Examiner's Findings or the Record of Action, as appropriate.

### 15.11-2 Reviewed Forms Listing

To facilitate the compliance review, a "Reviewed Forms List" is provided in the appendix. The "Revised Forms List" contains the following information: the form supplier's name, the form number and revision date, the use of the form (e.g., loan application, Truth-in-Lending disclosure, etc.), and identification of any problem areas noted during the review of the form (with appropriate regulation section cited). If a national form supplier modifies a form for use in a particular state, that form will be listed in the regional listings, not in the central office listing.

The "Reviewed Forms Listing" provided should not be interpreted as a comprehensive listing of forms used by credit unions. However, the listing should be referred to by the examiner, when appropriate, to identify consumer compliance violations.

### 15.11-3 Compliance Review Procedures

The consumer compliance review procedures that will be followed in all examinations are described in the following paragraphs. It is important to note that the Consumer Compliance Checklist is not a summary of the compliance review steps. For example, several compliance checklist questions are prefaced with the remark "Is there any evidence that . . .?" These questions should be answered based on the examiner's observations made during the course of routine examination steps. No special compliance review steps should be performed to complete these prefaced questions. Furthermore, it is intended that the compliance checklist be filled out upon completion of the examination so that all observations can be recorded.

Lastly, the checklist is for NCUA internal use only. It is not to be left with the credit union. Accordingly, all exceptions should be recorded in the Examiner's Findings, Loan Exceptions, or Record of Action, as appropriate. The explanations to the checklist are contained in the appendix to this section.

#### 15.11-3.1 Truth-in-Lending (Regulation Z)

The Truth-in-Lending Act was passed by Congress in 1968. Regulation Z implemented the Act in July 1969. Since that time, a series of amendments have added provisions, such as the Fair Credit Billing Act, to the Truth-in-Lending Act and Regulation Z. On March 31, 1980, Congress passed the Truth-In-Lending Simplification and Reform Act. A substantially revised Regulation Z was drafted and implemented on March 31, 1981. For the period April 1, 1981, through September 30, 1982, credit unions had the option of complying with the "old" Regulation Z or the "revised" Regulation Z.

Effective October 1, 1982, all loans granted must be in compliance with the revised regulation. Since examiners generally will be reviewing loans granted after October 1, 1982, they need to be concerned only with the provisions of Regulation Z as revised March 31, 1981.

The Manual of Laws Affecting Federal Credit Unions contains an in-depth analysis and a discussion of all provisions of Regulation Z. The Federal Reserve Board's Official Staff Commentary provides considerable insight to the provisions of the regulation.

The following minimum compliance review procedures will be followed during each review:

> (1) Determine if the Truth-in-Lending disclosure forms have been reviewed in the regional or the central office. This can be accomplished by checking the form name, number, and revision date to the "Reviewed Forms Listing."
>
> If the form has been reviewed, the exceptions noted on the "Reviewed Forms Listing" should be cited in the Examiner's Findings or the Record of Action, as appropriate. It should be emphasized to management that compliance is ultimately the credit union's responsibility. The fact that the form supplier provided a deficient form will not protect the credit union from civil liability.
>
> If the form is not on the listing, the examiner should not review the form. Form reviews are time consuming and involve many complex issues of law, regulation, and interpretation. Instead, the examiner should determine if the credit union has a written non-NCUA review of the form. If not, the examiner should indicate to the credit union that it obtain a written review from its attorney or their bonding company. However, the examiner should clearly indicate to the Federal credit union that it is only a recommendation to obtain a written review and that there is no legal requirement for such a review.

In all of the above situations, the examiner will complete the asterisked form review questions on the Checklist. If the form has been reviewed by NCUA, the results of the review (i.e., compliance/non-compliance) will be indicated on the Checklist. If the form is not on the NCUA reviewed form listing, the asterisked questions will be marked "N/R" (i.e., not reviewed). Most league forms and general supplier forms will be on the regional office or the central office listing. Generally, only those forms custom developed by individual credit unions should result in an "N/R" response on the compliance checklist.

The forms which would be involved in this portion of the examination are: the closed-end credit disclosure form, the open-end credit initial disclosure form, and the open-end credit periodic statement of account. The closed-end disclosure and the open-end initial disclosure normally will be contained in any loan files which are reviewed. Alternatively, the examiner may request the credit union to supply blank copies of the forms currently being used.

(2) Review disclosure forms for proper completion. This step involves a review of those items, such as the annual percentage rate, which are manually recorded on the disclosure form. The examiner will determine that the information is recorded on the disclosure form and that the information is accurate as follows:

a. The examiner will test the accuracy of the disclosed annual percentage rate (APR), finance charge, amount financed, payment schedule, and total of payments. This testing can be completed in one easy step with a TI calculator using the instructions in the TI Keystroke Manual. This procedure applies only to closed-end credit loans.

b. For open-end loans, the credit union should determine that the periodic rate and the APR are disclosed.

During this review, the examiner should be alert to the appropriateness of any other items manually entered on closed-end and open-end disclosure forms and that the disclosed interest rate is, in fact, the interest rate being imposed by the credit union.

The examiner will review the disclosure forms in those loan files reviewed for other purposes. Accordingly, a special selection of loans for consumer compliance review should not be conducted. As discussed in section 8 of the Examination Chapter, loan files may be pulled for various reasons. The examiner will select loans from these files for compliance review. The examiner should review only enough loans to determine that the credit union is properly completing the disclosure forms. In small credit unions, reviewing only one or two loans may be adequate. In larger, more complex credit unions, reviewing different types of loans (e.g., real estate, open-end, closed-end, etc.) may be necessary.

If violations are found in the calculation or the disclosure of the loan, the examiner should attempt to determine the cause of the violation(s). Discussions with FCU staff can often reveal the cause. Generally, if an additional loan review is necessary, the examiner should not review more than one or two additional loans when making this determination.

(3) One consistent problem area which has been experienced in credit unions involves disclosures for optional credit life and accident insurance (CDI, TDI, etc.). To exclude the insurance cost from the finance charges, the credit union must disclose that the insurance is optional and the cost and obtain the member's signature or initials. The insurance disclosure is normally part of the disclosure form and, therefore, reviewed before being placed on the "Reviewed Forms Listing." The examiner should determine whether the credit union offers such insurance. If the credit union does offer such insurance, the examiner is only to determine if the credit union has an insurance disclosure form (usually it is part of the Truth-in-Lending disclosure form), not to review its adequacy. It is a violation for a credit union to offer credit life or disability insurance and to fail to provide a disclosure. Such a violation should be documented in the Examiner's Findings or the Record of Action, as appropriate.

(4) Review for rescission or credit sales transactions.

a. The Manual of Laws discusses the "right of rescission" in detail. Briefly, the right of rescission applies when the credit union grants a loan secured by the member's residence. In such a loan, the credit union must give the member a "right of rescission notice" which sets forth the member's rights regarding the transaction. Failure to provide such a notice can lead to the credit union's inability to enforce collection of the loan.

The examiner is to determine if loans subject to the right of rescission are granted by the credit union. This usually can be accomplished by simply asking the officials if they grant such loans. If so, the examiner will determine whether the credit union has a "right of rescission" form to give members obtaining such loans. Appendix H-8 of Regulation Z contains a sample "right of rescission" form. Failure to provide such a form on appropriate loans is a violation and should be cited in the Examiner's Findings or the Record of Action, as appropriate.

b. Credit sales transactions are discussed in detail in the Manual of Laws. The most common occurrence in a credit union which constitutes a credit sale is when a credit union repossesses an automobile, sells the auto, and grants a loan to enable the individual to purchase it. In such situations, specific disclosures, in addition to those required for "normal" loans, are required. Appendix H-1 in Regulation Z contains a model disclosure for a credit sale transaction.

The examiner is to determine if the credit union enters into such transactions. This can be accomplished easily by noting the disposition of repossessed collateral, if any, during other examination steps, or the examiner can explain the most common credit sale transaction and ask the officials if they ever have any. If the credit union does have such transactions, the examiner needs only to determine if the credit union has a credit sale disclosure form. Failure to make credit sale disclosures when required is a violation and should be cited in the Examiner's Findings or Record of Action, as appropriate.

(5) Review periodic statements of account. The periodic statement is an integral part of open-end disclosures. Numerous disclosure requirements are imposed on this statement, as discussed in the Manual of Laws. The examiner's review of this area will be limited to only the following substantive open-end credit areas. The examiner will review at least one periodic statement to determine whether the annual percentage rate and the finance charge are disclosed. The examiner should also determine that the corresponding APR is consistent with the corresponding APR on the initial disclosure. Furthermore, the examiner will determine that statements are distributed at least quarterly. Failure to comply with any of these provisions is a violation and should be cited in the Examiner's Findings or the Record of Action, as appropriate.

(6) Section 608 of the Truth-in-Lending Simplification and Reform Act is entitled "Restitution." This section requires Federal regulatory agencies (including NCUA) to order creditors to make monetary adjustments (restitution) to the accounts of consumers in cases where a disclosure error resulted in an understated APR or finance charge. The "Restitutuon Policy Guide" summarizes the provisions of Section 608, defines applicable terms, and discusses corrective action periods.

In general, restitution is required when a credit union discloses an APR or a finance charge which is less than the APR or the finance charge which would actually be collected if the loan was paid according to schedule. Following is a listing of the most common situations in credit unions which might require restitution:

a. Failure to disclose the annual percentage rate;

b. Understatement of the annual percentage rate or the finance charge;

c. Failure to provide credit insurance disclosures;

d. Use of a credit insurance disclosure form which is inadequate;

e. Failure to adjust the annual percentage rate and the finance charge for prepaid finance charges such as loan origination fees, points, etc.; and,

f. Failure to adjust the finance charge for payment irregularities, such as odd first payment periods, skip payments, etc.

If restitution appears to be required, the examiner will handle the situation in accordance with established regional policy.

### 15.11-3.2 Equal Credit Opportunity (Regulation B)

The Equal Credit Opportunity Act (ECOA) and its implementing Regulation B are designed to protect consumers, including credit union members, from prohibited discrimination. Discrimination is defined in Regulation B as treating one loan applicant or group of applicants less favorably than others on a prohibited basis. Discrimination in any aspect of a credit transaction on the basis of sex, marital status, race, color, religion, national origin, age, receipt of public assistance income, or the good faith exercise of rights under the Consumer Credit Protection Act is prohibited. The Manual of Laws provides an in-depth discussion of Regulation B requirements. NCUA is designated as the enforcing agency with respect to Federal credit unions. The ECOA also provides for severe civil and criminal penalties in cases of noncompliance.

The Federal Reserve Board issued revisions to several provisions of Regulation B on December 16, 1985. Although the changes take effect immediately, creditors have the option to continue complying with the previous Regulation until October 1, 1986. Changes in the Regulation include procedures in dealing with incomplete loan applications, a greater selection of sample forms for information to applicants of the reasons for credit denial, and a revised definition of applicant to give guarantors legal rights when there is an alleged violation by a creditor of the Regulation's signature provisions. The creditor's responsibility in recording "government monitoring" information from loan applicants seeking home or home refinancing mortgages has also been revised. Furter comment is provided in the appropriate subsections.

Reviewing for prohibited credit discrimination is one of the most difficult parts of the review. Discriminatory patterns and even individual instances of discrimination may be hard to detect. Rarely will the examiner encounter outright, blatant instances of discrimination. In most cases, the officials will be unaware that their actions have had a discriminatory effect upon some members. The officials will have enacted the discriminatory policies and/or practices out of an honest concern for the financial condition of the credit union. This is because most discriminatory acts are due to incorrect but long-held general assumptions about certain segments of society. Nevertheless, prohibited discrimination in any form, whether against whites or blacks, men or women, young or old, is illegal.

Discrimination can occur in many areas. Following is a list of the more probable areas: establishment of lending policies, advertisement of loan services, format and content of the loan application, loan interviews, evaluation of loan requests, and debt collection activities.

The following minimum procedures will be followed during all compliance reviews:

(1) The examiner will remain alert to policies and/or practices which might give rise to prohibited discrimination. This is particularly true during the review of board minutes, lending policies, loans, and debt collection activities. It also is important when reviewing advertising material, loan interviews, and various other activities within the credit union. Violations involving prohibited discrimination will be handled in accordance with instructions in paragraph (5) of this subsection.

(2) Determine if the loan application and the adverse action notice have been reviewed in the regional or the central office. This can be accomplished by checking the "Reviewed Forms Listing."

If the form has been reviewed, the exceptions noted on the "Reviewed Forms Listing" will be cited in the Examiner's Findings or the Record of Action, as appropriate. As with the Truth-in-Lending forms, the fact that the form supplier provided a deficient form will not protect the credit union from civil liability.

If the form is not on the listing, the examiner should not review the form. The form should be handled in accordance with the procedures used for non-NCUA reviewed forms under subsection 15.11-3.1 (Truth-in-Lending).

(3) If real estate loans (loans to purchase residential real estate and secured by a lien on the property) are reviewed, the examiner will determine whether "government monitoring information" was requested. On these loans, Regulation B requires that the credit union request the race, national origin, sex, marital status, and age of the applicant. Effective October 1, 1986, if the applicant does not volunteer this information, the loan officer/credit committee is required to visually observe and note the loan applicant's race, national origin, sex, marital status, and age in the appropriate section of the application. The member must also be informed of the credit union's need to know the information either orally or in writing.

(4) While reviewing the credit committee minutes, the examiner will select one or two loan applications which were rejected. The examiner will then request a copy of the adverse action notice which was provided to the member. The examiner will determine whether an adverse action notice which provided the reason for rejection was provided to the member. If the reason for rejection was stated in the credit committee minutes, the examiner will determine whether the same reason was stated on the adverse action notice. Failure to provide an adverse action notice or to provide the reason for rejection (or to provide an inaccurate reason) is a violation and and will be handled in accordance with paragraph (5) below.

(5) Substantive provisions of the Equal Credit Opportunity Act/Fair Housing Act are as follows:

- Discouraging applicants on a prohibited basis;
- Using credit criteria in a discriminatory manner in evaluating applicants;
- Imposing different terms on a prohibited basis;
- Requiring co-signers on a prohibited basis;
- Failing to furnish separate credit histories; and,
- Failing to provide adequate adverse action notices.

The examiner will be especially cognizant of these types of violations and will handle such violations in accordance with established regional policy.

### 15.11-3.3 Electronic Fund Transfers (Regulation E)

The Electronic Fund Transfer Act (EFTA) became effective May 10, 1980. The EFTA and its implementing Regulation E provide a basic framework establishing the rights, liabilities, and responsibilities of participants in electronic fund transfer systems. The most important rights involve liability for unauthorized use of an access device (e.g., debit card), the right to receive certain disclosures, the right to stop payments, and the right to dispute errors. EFTA has civil and criminal liabilities for violations of its provisions and designates NCUA as the enforcement agency for Federal credit unions.

Electronic fund transfers (EFTs) apply only to share transactions, not to loan transactions. The most common examples of EFTs are automated teller machines (ATMs), telephone bill payment services, point of sale (POS) terminals, and preauthorized transfers from or to a member's account. Under certain situations, payroll deductions can be EFTs. The Manual of Laws contains an in-depth analysis of the regulation.

In all consumer compliance reviews the examiner will follow these minimum steps:

(1) Determine if the credit union has EFTs. This can usually be accomplished by normal observation during the course of the examination and by asking the officials if they have ATMs, POS terminals, telephone bill payment services, or fund transfers via an automated clearing house (ACH).

(2) If the credit union has EFTs, determine whether the credit union provides initial disclosure forms and periodic disclosure statements of accounts.

(3) Determine if the initial disclosure and the periodic statement are on the "Reviewed Forms Listing." If they are, the examiner will cite any violations noted on the Listing in the Examiner's Findings. If not, the forms will be handled in accordance with the procedures used for non-NCUA reviewed forms under section 15.11-3.1 (Truth-in-Lending) of the Guide.

(4) Determine whether the forms are being completed and provided to members. This can be accomplished by asking the officials for the credit union copy of the disclosure given the member. When looking at these forms, the examiner should not review the forms but should remain alert to the possibility of inaccurate information being recorded on the forms.

### 15.11-3.4 Real Estate Settlement Procedures Act (HUD Regulation X)

The Real Estate Settlement Procedures Act (RESPA) became effective on June 20, 1975. RESPA is implemented through Regulation X of the Department of Housing and Urban Development (HUD). HUD Regulation X should not be confused with FRB Regulation X discussed in section 15.9. The purpose of RESPA is to provide borrowers with certain information relating to the cost of financing and settlement in real estate loans. RESPA also prohibits certain practices, such as kickbacks, and places limitations on escrow accounts. RESPA applies to loans to purchase residential real estate and secured by a first lien on that property. The Manual of Laws provides an in-depth analysis of the Act and the regulation.

The following minimum procedures will be followed during all compliance reviews:

(1) Determine if the credit union grants loans subject to RESPA. This usually can be accomplished by normal observation during the course of the examination or by asking the officials if they grant such loans.

(2) If the credit union has loans subject to RESPA, determine if it has the RESPA booklet, the good faith estimate form, and the HUD-1 form available for use when needed.

(3) If any real estate loans subject to RESPA are reviewed during other portions of the examination, determine if the borrowers were supplied the RESPA booklet, the good faith estimate, and the HUD-1 form, as required. This can usually be accomplished by reviewing procedures used by the credit union and by checking the loan file for credit union copies of the good faith estimate and the HUD-1 form.

(4) Violations should be cited in the Examiner's Findings or the Record of Action, as appropriate.

### 15.11-3.5 Other Laws and Regulations

Following is a listing of other consumer laws and regulations which are pertinent to credit union operations. Most are discussed in the Manual of Laws. The examiner should be alert to any apparent violations of the provisions of the laws and the regulations. If violations are noted, they should be cited in the Examiner's Findings or the Record of Action, as appropriate:

(1) Holder in Due Course - This is a Federal Trade Commission trade rule. Its official name is the "Preservation of Consumers Claims and Defenses Rule." This trade rule applies primarily to those credit unions which are affiliated with a merchant by any formal or informal understanding, procedure, arrangement, or course of dealing.

(2) Federal Fair Housing Law - This law prohibits credit unions from discriminating in any aspect of housing, including lending. It prohibits discrimination on the basis of race, color, religion, sex, or national origin. The provisions of this Act are substantially overlapped by the Equal Credit Opportunity Act.

(3) National Flood Disaster Protection Act - This Act is implemented by Part 760 of NCUA's Rules and Regulations. The purpose of the Act is to restrict lending secured by improved property in designated flood-prone areas unless appropriate insurance is obtained.

(4) Home Mortgage Disclosure Act - This law is intended to provide for the development of certain data regarding creditors' real estate lending practices. It is implemented by the Federal Reserve Board's Regulation C.

(5) Fair Credit Reporting Act - The Act is designed to regulate the credit reporting industry; place disclosure obligations on users of credit reports; and ensure fair, timely, and accurate reporting of credit information.

(6) Fair Debt Collection Practices Act - The Act prohibits "unfair" debt collection practices by "debt collectors."

(7) Right to Financial Privacy Act - This Act is intended to protect the personal financial privacy of individual consumers of financial institutions (credit union members) by restricting access to the financial records a credit union has regarding its members.

(8) Fair Credit Practice Rule - This is a Federal Trade Commission rule which became effective March 1, 1985. The rule prohibits "confession of judgement" clauses, "waiver of exemption" of state law sheltering the consumer's home, "assignment of future wages", provisions permitting creditors to repossess any consumer's household goods beyond those for which the credit union is extending credit, "pyramiding" of late charges and the requirement that cosigners be provided a notice information them of the nature of the obligation and its potential liability.

### 15.11-3.6 Other NCUA Laws and Regulations

Following is a listing of other NCUA laws and regulations which are pertinent to credit union operations. The examiner should be alert to any apparent violations of these requirements. If violations are noted, they should be cited in the Examiner's Findings or the Record of Action, as appropriate.

(1) Insurance and Group Purchasing Activities (Part 721 of the NCUA Rules and Regulations) - This regulation permits Federal credit unions to make insurance and group purchasing plans involving outside vendors available to the membership. Federal credit unions can endorse plans and can perform administrative functions on behalf of the vendors. The credit union may also be reimbursed by a vendor for its performance of administration functions in accordance with limitations specified in the regulation.

(2) Statutory limitation on interest rates (Section 107(5)(A)(vi) of the FCU Act) - The Act specifies that the rate of interest on a loan may not exceed 15 per centum per annum on the unpaid balance inclusive of all finance charges. (The Act also permits the NCUA Board to increase this limit to 21% if certain conditions are met.) Collection of a rate of interest in excess of the statutory limitation is generally viewed as a usurious act. The examiner will primarily encounter usury questions in two areas: compensating balances and recomputation for rebates. These two concepts are addressed in NCUA Interpretation 79-9 and in Section 6110.4 of the Accounting Manual, respectively.

### 15.12 Internal Revenue Service Reporting Requirements

Although not formaly charged with the responsibility of enforcing the regulations of the Internal Revenue Service, the examiner should bring to the attention of credit union management any obvious violations. The examiner's concern in non-compliance with Internal Revenue Service regulations by the credit union relates to the dollar penalties that might result. If the violations are numerous, the credit union could potentially incur significant dollar fines which might adversely affect the financial condition of the credit union. The following are IRS regulations commonly present in the operation of a credit union:

1. Form 1099 Reporting - The Interest and Dividend Compliance Act requires the credit union to:

   --- contact members in writing, requesting certification of their social security numbers under penalties of law;
   --- initiate backup withholding on accounts with missing or obviously incorrect social security numbers or if notified by the IRS;
   --- report member dividends on paper 1099 forms; and
   --- report member dividends to the IRS on magnetic media if the credit union has 50 members or more unless granted an annual undue hardship exemption.

2. Federal Withholding - If salaries are paid, the credit union must comply with the withholding provisions of the law, including the distribution of the W-2 form at year-end.

3. IRA Reporting - If the credit union offers Individual Retirement Accounts, the form 5498 must be prepared for distribution to themember and the IRS.

4. Mortgage Interest Reporting - The regulation requires that the credit union report interest of $600 or more a year paid by borrowers on most real estate-secured loans. The form 1098 is used to report the interest for distribution to the IRS and the member.

A record of action may be appropriate if the violations are repetitive and/or material in nature.

### 15.13 Workpapers and References

(1) Workpapers

- a. NCUA 2013, Consumer Compliance Checklist
- b. NCUA 2360, Report on Security Measures
- c. NCUA 2460, Over/Under Payment
- d. NCUA 4501, Report of Officials
- e. FR 4789, Currency Transaction Report
- f. FR 4790, Report of International Transportation of Currency or Monetary Instruments
- g. FR G-1, Quarterly Report of Margin Securities
- h. FR G-2, Deregistration Request
- i. FR G-3, Annual Report of Margin Securities
- j. FR G-4, Purpose Statement
- k. FR X-1, Borrowers Who Obtain Securities Credit

(2) References

- a. Federal Credit Union Act
  1. 105 - Fees
  2. 107 - Interest
  3. 201 - Share Insurance
  4. 304 - CLF Stock Subscriptions

- b. NCUA Rules and Regulations
  1. 721 - Insurance and Group Purchasing
  2. 748 - Minimum Security Devices and Procedures
  3. 749 - Records Preservation Program

- c. Accounting Manual for Federal Credit Unions
- d. NCUA Interpretative Ruling 79-9
- e. Manual of Laws Affecting Federal Credit Unions
- f. Financial Recordkeeping and Currency and Foreign Transactions Reporting Act
- g. Monetary Control Act of 1980
- h. Regulation D, Reserve Requirements of Depository Institutions
- i. Regulation G, Securities Credit by Persons Other Than Banks, Brokers or Dealers
- j. FRB Regulation X, Rules Governing Borrowers Who Obtain Securities Credit
- k. Federal Election Campaign Act
- l. TI Keystroke Manual

# APPENDIX

## EXPLANATIONS TO THE CONSUMER COMPLIANCE CHECKLIST

## REGULATION Z

### GENERAL

1. Disclosures must be based on the legal obligation between the borrower and credit union. The legal obligation will ordinarily be the loan contract (i.e., the note) entered into by the parties. Payroll deductions, skip payments or long odd days cannot be considered in the disclosure calculation unless they are part of the legal obligation. If there is any doubt as to what terms or documents constitute the "legal obligation," the FCU should seek legal advice.

2. The notice of rescission gives the owner and co-owner(s) of real estate collateral the right to cancel a credit transaction. No such cancellation right is afforded for first mortgages to finance the purchase of a dwelling. But the right of rescission does apply when a residence is otherwise used as collateral for a consumer loan. The period within which the member may exercise the right to rescind runs for 3 business days from a specified point in time. The loan proceeds cannot be disbursed until the 3-day "cooling off" period has expired.

Additional rescission rules apply to open-end credit plans as discussed in the Manual of Laws.

3. Credit insurance (primarily credit disability and/or life), when paid for by the borrower, must be included in the finance charge and APR calculation, unless the FCU provides the disclosures required by Section 226.4(d). These disclosures are:

a. The insurance coverage is not required and this fact is disclosed in writing.

b. The premium for the initial term of insurance coverage is disclosed in writing. If the term of insurance is less than the term of the transaction, the term of insurance shall also be disclosed. The premium may be disclosed on a unit-cost basis only in open-end credit transactions, closed-end credit transactions by mail or telephone under Section 226.17(g), and certain closed-end transactions that have limitations on the indebtedness subject to coverage.

c. The member signs or initials an affirmative written request for the insurance after receiving the above disclosures concerning the cost and optional nature of the plan.

4. Violations of these provisions may occur, for example, when an FCU has changed its terms without reprinting a preprinted APR or periodic rate.

5-8. See Manual of Laws

## OPEN END CREDIT

9. To qualify as open-end, the loan plan must be extended under a plan in which:

a. The credit union reasonably contemplates repeated transactions.

b. The credit union may impose a finance charge from time to time on an outstanding unpaid balance.

c. The amount of credit that may be extended to the member is generally made available to the extent that any outstanding balance is repaid.

The three most typical open-end plans in credit unions are the special loan plan, a line of credit and a credit card plan. Open-end plans can include secured and unsecured subaccounts.

## INITIAL DISCLOSURE

10. Often times this disclosure will be made as follows: "For loans secured by _______, the periodic rate is _________ percent per _________ which corresponds to an ANNUAL PERCENTAGE RATE of ________ percent." If different rates apply to different features of the same plan, the different rates must be disclosed.

11-12. See Manual of Laws

## PERIODIC STATEMENT

13. The corresponding APR disclosed on the periodic statement must reflect the corresponding APR disclosed on the initial disclosure. The APR for the statement period will also equal the corresponding APR if there are no finance charges other than interest.

Each type of finance charge (e.g., interest charges, transaction charges, etc.) imposed during the period must be separately itemized.

14. The requirement to furnish quarterly statements for open-end accounts is contained in the "billing cycle" or "cycle" definition of Section 226.2(a)(4).

15. The long form notice (form G-3 in appendix G of the regulation) must be sent annually at intervals of not less than 6 months nor more than 18 months unless the "alternative summary statement" is sent with each periodic statement (form G-4 in appendix G).

16. See Manual of Laws

## CLOSED-END CREDIT

17. The regulation defines finance charge as "the cost of consumer credit as a dollar amount." It includes any charge payable directly or indirectly by the borrower and imposed directly or indirectly by an FCU as an incident to or a condition of the extension of credit. The finance charge does not include any charge of a type payable in a comparable cash transaction. In addition, any finance charge paid before the extension of credit must be included in the finance charge and included in the computation of the "amount financed." Section 226.4(b) list examples of finance charges. However the charges and fees shown in these examples may be excludable from the finance charge under Sections 226.4(c), (d) or (e). For example, appraisal fees mentioned as a finance charge in Section 226.4(b)(4) are excluded from real property or residential mortgage transactions under 226.4(c)(7) if the fees are bona fide and reasonable in amount.

In calculating the finance charge on a simple interest loan the FCU may disregard any irregularity in the first payment period that falls within the limits shown below and any payment schedule irregularity that results from the irregular first payment period. The minor irregularity limits are as follows:

For transactions with a term of:

| | Less than 1 year | 1 to less than 10 years | 10 years or more |
|---|---|---|---|
| Weekly | 1 to 20 days | 0 to 28 days | 0 to 39 days |
| Biweekly | 8 to 27 days | 3 to 35 days | 0 to 46 days |
| Semi monthly | 9 to 28 days | 4 to 36 days | 0 to 47 days |
| Monthly | 24 to 43 days | 19 to 51 days | 0 to 62 days |

18. The determination of the APR is governed by Section 226.22 and appendix J of the regulation. The APR may be computed using Volume 1 of the Federal Reserve's Annual Percentage Rate Tables. Commercially prepared tables are also available as an aid for FCU's that charge interest only. If prepaid finance charges or other costs are included in the APR calculation, then adjustments to the APR may be necessary. Specially programmed calculators may be purchased to assist in performing any of these calculations. As a general rule, for regular transactions the annual percentage rate shall be considered accurate if it is not more than 1/8 of 1 percentage point above or below the "true" rate calculated under the regulation.

Under Section 226.17(c)(3) an FCU may disregard the effects of the following in making calculations and disclosures of the FC and APR:

a. That payments are collected in whole cents.

b. That dates of scheduled payments and advances may change because the scheduled date is not a business day.

c. That months have different numbers of days.

d. The occurrence of a leap year.

19. The payment schedule includes the number, amount and timing of payments (e.g., monthly). The total of payments must equal the amount of the payments times the number of payments.

20. In a credit sale, the FCU must disclose the "Total Sale Price" and "down payment" with a descriptive explanation. This disclosure must be made in addition to all the other closed-end disclosures specified in Section 226.18.

This requirement applies only if the FCU: (a) owns the property or merchandise, and (b) finances the acquisition of the property (i.e., makes a loan to the purchaser).

21-24. See Manual of Laws

## EXPLANATIONS - REGULATION B

1. The general rule (Section 202.4) is that no creditor may discriminate on a prohibited basis in any aspect of a credit transaction. The prohibited bases are: race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to enter into a binding contract), receipt of income from any public assistance program, and the good faith exercise of rights under the Consumer Credit Protection Act (i.e., filing a complaint or suit against the credit union alleging a violation under TIL, ECOA, or FCRA). The latter means that the credit union may not discriminate against an applicant who filed a complaint under one of the consumer acts and therefore is considered a "troublemaker." "Any aspect of a credit transaction" means that Regulation B protects the consumer from the period before an application is made (discouraging applications on a prohibited basis is impermissible) until 7 years after the loan is paid off (the furnishing of credit information is covered).

If, despite the general prohibitions, a credit union has a field of membership which is confined to persons in one of the categories against which discrimination is prohibited, such as a religious group, it is not a violation to deny membership to persons outside that field of membership. Likewise, it is not a violation to refuse to accept a loan application from a nonmember (nor would this be considered an adverse action) since membership is not a prohibited basis of discrimination under ECOA. Within a credit union's field of membership, however, no person or group of persons may be rejected or discouraged on a prohibited basis.

In addition, legislative history of the ECOA indicates that loan policies which have the effect of discriminating on a prohibited basis may violate the Act regardless of the creditor's intent. For example, if payroll deduction is required as a condition for obtaining a loan and, as a result, spouses of primary members are not able to obtain credit, this may be challenged under ECOA. (e.g., if most of the employees of the sponsor are middle-aged men and other members are wives and children of the men, requiring payroll deduction may prevent the wives and children from obtaining loans, which may subject the credit union to sex or age discrimination charges.) See footnote 7 of Regulation B (Section 202.6(a)) and the Manual of Laws.

Listed below are other examples of potentially discriminating policies or procedures:

a. Refusing to grant credit to retirees.

b. Extensive seniority/length of employment scales (usually encompassing several years) with no evidence of a business or safety and soundness need for such a policy.

c. Refusing to consider public assistance income (social security, welfare, aid to dependent children, etc.)

d. Refusing to grant credit to family members (particulary spouses) when the employee member is largely composed of people of the same sex.

e. Unreasonably high minimum income requirements.

2. The credit union must not discount or exclude from consideration, the income listed by an applicant or his/her spouse for prohibited reasons or because it is derived from part-time employment, public assistance or pension or similar benefits. It may, however, consider, the amount and probable continuance of such income in evaluating an applicant's creditworthiness. Also, regarding receipt of public assistance, it may consider the length of receipt of such income and the applicant's intent to remain eligible for those benefits. Regarding alimony, child support or separate maintenance payments, if the applicant has chosen to disclose such income, the credit union must consider payments as income to the extent that they are likely to be consistently made. (See Section 202.6(b)(5)).

3. If an applicant requests unsecured credit and relies in part upon property to establish creditworthiness or if the applicant resides in (or the property is located in) a community property state, the credit union may require the signature of a spouse on any instrument reasonably believed to be necessary under applicable state law to make that property available to satisfy the debt in the event of default. (See Section 202.7(d)(3)). If an applicant requests secured credit, the credit union may require the signature of the applicant's spouse (or other person) on any instrument reasonably believed to be necessary under state law to make the property being offered as security available to satisfy the debt in the event of default. The credit union cannot, however, require a spouse to sign the note in addition to the lien instrument if under state law the signature of the spouse on the note would not be necessary for creating a valid lien, passing clear title, or assigning earnings.

4. Notification of action taken must be made within:

a. 30 days after receiving a completed application.

b. 30 days after taking adverse action on an uncompleted application. (However, effective December 16, 1985, the credit union is not required to provide a written notice of loan denial for an imcompleted loan application.)

c. 90 days after making an unaccepted counter offer.

Failure to give the member an accurate reason(s) or no reason at all may be a violation of the law. Therefore, special attention should be given to the accurate reflection of credit committee/loan officer actions on the adverse action notice.

5. While the credit union must request this information of the applicant and joint applicant for a loan to purchase residential real property, the latter are not required to supply the information. If they choose not to, however, that fact must be noted on the form. However, effective October 1, 1986, the loan officer/credit committee is required, if the information is not volunteered, to visually observe and note the loan applicant's race, national origin, sex, marital status, and age in the appropriate section of the application. The member must also be informed of the credit union's need to know the information either orally or in writing. A model loan application for loans of this type is shown on page 36 of Regulation B. If the credit union elects, this information can be obtained on a separate form that refers to the application. This information should not be requested for anything other than a purchase money first lien. However, the credit union may furnish the monitoring information required by FHA when the applicant is applying for a Title 1 loan. (See Sections 202.5(b)(2) and 202.13.)

6-7. See Manual of Laws

## EXPLANATIONS - REGULATION E

### GENERAL

An EFT is a transfer of funds not initiated through a paper instrument but through an electronic terminal, telephone, computer or magnetic tape. It includes, but is not limited to, point of sale transfers, automated teller machine transfers, certain direct deposits and withdrawals, and transfers initiated by certain telephone transfer plans. The regulation applies to share accounts and not to loan accounts.

Major exemptions from EFT include:

--- An exemption for credit unions under 25 million in assets for preauthorized transfers by government agencies and private corporations (such as Social Security, electronic payroll deposits and electronic insurance payments).

--- The transfer of funds in response to a member's telephone request is not an EFT unless there is a written plan or agreement between the member and the credit union (i.e., prearranged plan).

--- Automatic transfers between a member's accounts within a credit union are exempt. Intra-family transfers that occur automatically within a credit union are also exempt.

1. Disclosure must be given in a readily understandable written statement that the member may retain. There are no requirements concerning form matters such as type size, number of pages or relative conspicuousness of various terms.

2-3. See Manual of Laws

4. At the time an EFT is initiated at a terminal, the credit union must make available to the member a written receipt that clearly sets forth the information in Section 205.9(a)(1)-(6) as follows:

- The amount of the tranfer;
- The calendar date the member initiated the transfer;
- The type of transfer and the type of the member's account to or from which funds are transferred;
- A number or code that uniquely identifies the member initiating the transfer, the member's account(s), or the access device;
- The location or identification of the terminal at which the transfer was initiated; and
- The name of any third party to or from whom funds are transferred.

5. See Manual of Laws

6. For any account to or from which EFTs can be made, the credit union shall mail or deliver a statement for each month in which an EFT has occurred. A quarterly statement may be furnished if no transfer has occurred. Statement requirements in Section 205.9(b)(1)-(6) are as follows:

- * For each EFT occurring during the cycle:
  - --- The amount of transfer
  - --- The date of crediting or debiting
  - --- The type of transfer and account(s)
  - --- Electronic terminal location and description, if applicable
  - --- The name of any third party;
- * The number(s) of the member's account(s);
- * The total amount of any fees or charges for EFTs;
- * The balances in the member's account at the beginning and at the close of the statement period;
- * The address and telephone number to be used for inquiry or notice of errors, preceded by "Direct Inquiries To:" or similar language;
- * The telephone number the member may call to determine whether a preauthorized transfer to the account has occurred, if the credit union uses the 205.10(a)(1)(iii) notice procedure.

Additionally, if a member's account (other than passbook) may not be accessed by any EFT other than preauthorized transfers to the account (e.g., deposits), the credit union can provide the periodic statement quarterly.

7. Self-explanatory.

8. See Manual of Laws

## EXPLANATIONS - REGULATION X

### GENERAL

HUD Regulation X applies to all federally insured credit unions that make real estate loans secured by a first lien. See Section 5 of Manual of Laws for further discussion.

1. The HUD Booklet must be mailed or delivered to a borrower by not later than 3 business days after a loan application is received. The required content of the booklet is shown in appendix A of Section 5 of the Manual of Laws.

2. The form must be clear and concise. It must include the credit union's name. Section 3500.7(d)(1) also requires the following notice in BOLD type:

> "This form does not cover all items you will be required to pay in cash at settlement, for example, deposit in escrow for real estate taxes and insurance. You may wish to inquire as to the amounts of such other items. You may be required to pay other additional amounts at settlement."

3. The Uniform Settlement Statement (HUD 1) must be used by the credit union, or any person acting on its behalf, when conducting the settlement of a federally related mortgage loan. Directions on the completion of the form are contained in the RESPA Booklet in Appendix A of Section 5 of the Manual of Laws.

4. Section 3500.12 of HUD Regulation X provides that no fee shall be imposed or charge made upon any other person, as a part of settlement cost or otherwise, by a lender in connection with or on account of the preparation and distribution of the RESPA or Truth in Lending forms.

# NCUA/WO REVIEWED FORMS LIST

Standard abbreviations used in this appendix are:

OE - Open-end Credit
CE - Closed-end Credit
TIL - a Truth in Lending Disclosure
AL - Application for Loan
N - Note/Contract
SA - Security Agreement
CI - Credit Insurance Disclosure/Authorization
RE - Real Estate
ECO- an Equal Credit Opportunity Disclosure
EFT - an Electronic Fund Transfer Disclosure

This listing may be supplemented by the regional office as appropriate for each region, examiner, and/or state.

Problem areas listed regarding a supplier and/or form are generally based on the form itself. Other violations may occur if the FCU does not properly use or complete the form. Also, the listing of problem areas may or may not be all inclusive.

October 1986

# EXAMINER'S GUIDE

## Contents

Following is a listing of form suppliers which are included in this listing:

Aetna Life & Casualty

Anacomp, Inc.

Baron, Stuart J.

C & C Systems

CUDIS INSURANCE SOCIETY, INC.

CUNA Supply Corporation

Freimark & Thurston Agency, Inc.

I.C.C.I.

Katz, Richard J. & Company

Melchione, Joseph S.

Minnesota Mutual Life Insurance Company

National Credit Union Administration

Oak Tree Systems, Inc.

SRL Business System

T.O.P., Inc.

## Aetna Life & Casualty
Hartford, CT.

Aetna develops forms for use with its credit insurance products.

| Form No. and Revision Date | Use of Form |
|---|---|
| CE-OTC/APP 4-1-82 | CE AL |
| No problems noted | |
| OE-APP-FDST-IL-OBSP 4-1-82 | CE AL |
| No problems noted | |
| CE-OTC/DIS-FD-IL-SP 4-1-82 | CE TIL/SA/CI |
| 226.18(k)(2) - If the FCU imposes prepaid finance charges, the form would have to be modified. (TIL Checklist question 24)<br>226.18(p) - If the FCU imposed required deposits, the form would have to be modified. (TIL Checklist question 24) | |
| CE-OTC/DIS-FD-IL-OB 4-1-82 | CE/TIL/SA/CI |
| 226.18(k)(2) - If the FCU imposes prepaid finance charges, the form would have to be modified. (TIL Checklist question 24)<br>226.18(p) - If the FCU imposed required deposits, the form would have to be modified. (TIL Chicklist question 24) | |
| OE-APP-FD-IL-OBSP (front)<br>OE-APP-FDST-IL-OB (back) 4-1-82 | OE TIL/N/SA/CI |
| No problems noted | |
| OE-APP-FD-IL-OBSP (front)<br>OE-APP-FDST-IL-SP (back) 4-1-82 | OE TIL/N/SA/CI |
| No problems noted | |
| OE-FAV-OB 4-1-82 | OE Voucher |
| No problems noted | |

OE-FAV-SP 4-1-82 — OE Voucher

No problems noted

CE-MAIL/DIS-SP 1-1-82 — CE/TIL/SA/CI

226.17(a) -The terms "Annual Percentage Rate" and "finance charge" are not printed more conspicuously than other required disclosures. (TIL Checklist question 6)

226.18(k)(2) - If the FCU imposes prepaid finance charges, the form would have to be modified. (TIL Checklist question 24)

226.18(p) - If the FCU imposed required deposits, the form would have to be modified. (TIL Checklist question 24)

**Anacomp, Inc.**
Indianapolis, Indiana

OE Statement of Account for On-Line Users

Anacomp provides data processing services to credit unions, nationwide.

| Form No. and Revision Date | Use of Form |
|---|---|
| A-1 (No Date) | OE TIL/Statement of Account |

226.5(a)(2) - The term "Annual Percentage Rate" is not disclosed more conspicuously than other required disclosures (TIL Checklist question 6)

226.7(e) - The explanation of the method used to determine "the balance on which the finance charge may be computed" does not describe the effects of payments credits and debits on the loan balance. (TIL Checklist question 11)

## Stuart J. Baron, Attorney

Santa Monica, CA

Mr. Baron develops forms for a group of credit union clients located primarily on the west coast. His forms are modified American General loan forms.

| Form No. and Revision Date | Use of Form |
|---|---|
| Not assigned<br>226.17(a)(1) - The finance charge is more conspicuous than the annual percentage rate. These terms must be disclosed more conspicuously than any other disclosure, but one cannot be more conspicuous than the other. (TIL Checklist question 5)<br>226.18(k)(1) - The disclosure does not state whether or not a penalty may be imposed. (TIL Checklist question 24)<br>226.18(k)(2) - If prepaid FCs are assessed, the rebate disclosure would have to be made. (TIL Checklist question 24)<br>226.18(r) - If the FCU requires a deposit (RDB), the form would have to be modified. (TIL Checklist question 24) | CE N/TIL |
| Not assigned/revised 6/82<br>226.6(b) - The preprinted late charge disclosure would have to be modified to reflect each individual FCU's operations. (TIL Checklist question 12)<br>226.5(a)(2) - The term "annual percentage rate" is not more conspicuous than the topical headings. (TIL Checklist question 5)<br>226.6(c) - The disclosure lists "all" shares as collateral while the note excludes certain tax-exempt certificates. (TIL Checklist question 12) | OE N/TIL |

Not assigned/revised 6/82 OE and CE AL/ECO

202.5(c)(1) - Two questions at the bottom of the application ask if the "spouse" has ever declared bankruptcy or been co-maker on a loan. If an applicant for individual, unsecured credit (in a non-community property state) completed these questions, the inquiry would be illegal. (ECO Checklist question 6)

This review was conducted in July 1982. No resubmittals have been made since that date.

## C & C Systems
Irvine, CA

C&C is a forms system company that supplies credit unions located primarily on the west coast.

| Form No. and Revision Date | Use of Form |
|---|---|
| 40-01 (1982)<br>No problems noted | OE AL/ECO |
| 40-02 (1982)<br>No problems noted | OE TIL/Fixed rate APR |
| 40-03 (1982)<br>No problems noted | OE advance request voucher - TIL |
| 40-04 (1982)<br>No problems noted | OE advance request voucher - TIL |
| 40-05 (1982)<br>No problems noted | OE change in terms agreement - TIL |
| 40-06 (1982)<br>No problems noted | CE update/AL-ECO |
| 40-07 (1982)<br>No problems noted | OE variable rate disclosure - TIL |
| 40-08 (1982)<br>No problems noted | CE AL-ECO |
| 40-09 (1982)<br>226.18(k)(2) - If the FCU imposes prepaid finance charges, the form would have to be modified. (TIL Checklist question 24) | CE N/TIL |

| | |
|---|---|
| 40-11 (1982)<br>226.18(k)(2) - If the FCU imposes prepaid finance charges, the form would have to be modified. (TIL Checklist question 24) | CE co-maker's TIL and Loan Exception Request |
| 40-12 (1982)<br>No problems noted | OE/CE AL-ECO |
| 08-40-09 (1982)<br>226.18(k)(2) - If the FCU imposes prepaid finance charges, the form would have to be modified. (TIL Checklist question 24) | CE TIL with check |

## CUDIS INSURANCE SOCIETY, INC.
Madison, WI

CUDIS is affiliated with the CUNA/CUMIS insurance group. The forms are developed for use with their credit insurance. The CUDIS loan forms are called "Loanliner."

| Form No. and Revision Date | Use of Form |
|---|---|
| CMIG 7-430 (7/81) RTC | CE N/CI/TIL |
| 226.18(k)(2) - The form would have to be modified if an FCU had prepaid finance charges. (TIL Checklist question 24) | |
| D-150 SPN (1/82) | CE N/CI/TIL |
| 226.18(k)(2) - The form would have to be modified if an FCU had prepaid finance charges. (TIL Checklist question 24) | |
| CMIG 7-250 (1/82) | CE N/TIL |
| No problems noted | |

## CUNA Supply Corporation
Madison, WI

CUNA Supply markets a wide variety of loan forms. Their standard disclosure is named the "Z-1."

| Form No. and Revision Date | Use of Form |
|---|---|
| Z-1, number 11499 (2/82) | CE TIL |
| 226.18(k)(2) - If prepaid finance charges are assessed, the form would have to be modified accordingly. (TIL Checklist question 24) | |
| Z-2, number 11496 (2/82) | CE TIL - Credit Sale |
| 226.18(k)(2) - If prepaid finance charges are assessed, the form would have to be modified accordingly. (TIL Checklist question 24) | |
| Comb. Z-1, number 11502 (2/82) | CE N/TIL |
| 226.18(k)(2) - If prepaid finance charges are assessed, the form would have to be modified accordingly. (TIL Checklist question 24) | |
| 201-O.E.-3, number 11168 (1/82) | OE N/TIL |
| No problems noted | |
| 201-O.E.-3A, number 11174 (4/82) | OE N/TIL |
| No problems noted | |

## Freimark & Thurston Agency, Inc.
Dayton, OH

Freimark & Thurston markets a variety of insurance products to FCUs. Attorney Stephen D. Miles develops their forms for use with these products.

| Form No. and Revision Date | Use of Form |
|---|---|
| 9G55E778A-134 (no date) | CE N/TIL ECO |

226.18(m) - The statutory lien on shares is no longer a security interest; therefore, it cannot be in the FED box. (TIL Checklist question 24)

202.5 - The security agreement requests the signature of the spouse. A neutral term (e.g., co-owner) should be used to avoid illegal discrimination (i.e., discouraging, etc.). (ECO Checklist question 6)

**October 1986**

# EXAMINER'S GUIDE

## I.C.C.I.
Overland Park, Kansas

Inter-Continental Computing, Inc. (ICCI) is a subsidiary of Citicorp providing data processing to credit unions.

| Form No. and Revision Date | Use of Form |
|---|---|
| Not assigned | OE TIL/EFT, Periodic Statement of Account |

226.9(q)(2) - The billing error notice would have to be modified if an automatic debit program were offered. (TIL Checklist question 16)

226.5(a)(1) - The placement of the heading "The following disclosure pertains to open-end loan only" is unclear and confusing because the EFT notice and transactions codes apply to other types of account activity as well. (TIL Checklist question 5)

205.8 - The EFT notice does not list FCU's telephone number and address (nor is there a reference to the front of the statement if this information is located there). (EFT Checklist question 8)

October 1986

# EXAMINER'S GUIDE

## Richard J. Katz & Company
Rochester, NY

Katz is an insurance agency that has developed loan forms for use with its insurance products. The forms will be encountered primarily in New York State.

| Form No. and Revision Date | Use of Form |
|---|---|
| Not assigned - Entitled "Simplified Lending" | OE N/TIL, AL/ECO, CI |
| No problems noted | |
| N 100 (Revised 4/82) | CE N/TIL, CI |
| No problems noted | |

**Joseph S. Melchione, Attorney**
North Hollywood, CA

Mr. Melchione prepares loan forms for clients who are primarily located on the west coast.

| Form No. and Revision Date | Use of Form |
|---|---|
| 008-15 (no date)<br>No problems noted | CE TIL - Right of rescission, general |
| 008-16 (no date)<br>226.23(b) - The transaction to which rescission applies is not identified (e.g., no reference to the transaction date). (TIL Checklist question 2) | CE TIL, Right of rescission for refinanced credit |
| 008-41, 020-20 and 020-18 (no date)<br>226.17(a)(1) - The circumstances under which the variable rate (if applicable) may increase (i.e., the fact that the interest will be based on a rate 5 points above the U.S. T-bill rate). (TIL Checklist question 7)<br>226.17(a)(1) - If applicable, Keogh retirement accounts should be excluded from the contractual share pledge. (TIL Checklist question 5) | CE N/TIL |
| 20-26 and 20-07<br>226.5(a)(1) - The disclosure of a rebate of prepaid finance charges is not required for open-end credit. It should, therefore, be deleted to avoid confusing members. (TIL Checklist question 5)<br>226.5(a)(1) - If applicable, Keogh retirement accounts should be excluded from the contractual share pledge. (TIL Checklist question 5) | OE N/TIL |

## Minnesota Mutual Life Insurance Company
St. Paul, MN

Minnesota Mutual develops forms for use with its credit insurance products.

| Form No. and Revision Date | Use of Form |
|---|---|
| 81-6000 | OE/CE AL/ECO |
| No problems noted | |
| 81-6100 | CE N/CI/TIL |
| 226.18(k)(2) and 226.18(c)(iv) - If the FCU assesses prepaid finance charges, the form would have to be modified. (TIL Checklist question 24) | |
| 81-6300 | OE N/CI/TIL |
| No problems noted | |
| 81-6400 | OE Voucher/TIL |

## National Credit Union Administration
Washington, D. C.

### CE Application for Loan

The NCUA developed a model loan application in 1979. The form has been approved by the Federal Reserve Board and its proper use will insulate any credit union from liability under ECOA.

| Form No. and Revision Date | Use of Form |
|---|---|
| NCUA 6001 (4/79) | CE AL |

No problems noted

## Oak Tree Systems, Inc.

Oak Tree is a credit insurance broker serving primarily west coast credit unions.

| Form No. and Revision Date | Use of Form |
|---|---|
| FAA0040482F1 (1982) | OE TIL/N/AL/CI |
| 202.5 - If joint credit is offered, the spousal designation in the income section of the application may discourage an applicant from relying on a party other than the spouse. (ECO Checklist question 6) | |
| 202.5 - The application contains a signature line for the member and the spouse. If joint credit is offered, the borrower may be discouraged from applying for such credit with a party other than the spouse (ECO Checklist question 6) | |
| 226.7(a)(1) - The optional credit insurance disclosure does not adequately identify the "insured debt;" e.g. is it the gross indebtedness or net indebtedness. (TIL Checklist question 5) | |
| 226.6(b) - If filing or non-filing fees are charged to the member they must be disclosed as either a finance charge or other charge as applicable. (TIL Checklist question 12) | |
| OTS 5 FAA (10/82) | OE Voucher/SA |
| No problems noted | |
| OTS004/FAA (9/82) | OE TIL/N/AL/CI |
| 202.5 - The inquiry concerning the borrower's reliance on the spouse's income may not be acceptable for use with joint credit (ECO Checklist question 6) | |
| 202.5 - The application contains a signature line for the member and the spouse. If joint credit is offered, the borrower may be discouraged from applying for such credit with a party other than the spouse (ECO Checklist question 6) | |

OTS 6-FAA (10/82) OE Voucher

No problems noted

OTS0080682D1 and OTS0010682D1 (1982) CE/TIL/N/SA

226.18(k)(2) - If prepaid finance charges are assessed by the credit union, the form would have to be modified. (TIL Checklist question 24)

226.4(e) - If the FCU charges the member for filing or non-filing fees in accordance with the security agreement, then the disclosure would have to reflect these charges in order to exclude them as a finance charge (otherwise such charges must be considered finance charges). (TIL Checklist question 24)

OTS0020682D1 (1982) OE AL

202.5 - The inquiry concerning the borrower's reliance on the spouse's income may not be acceptable for use with joint credit (ECO Checklist question 6)

CHA0040482F1 (1982) OE AL/TIL

202.5 - The inquiry concerning the borrower's spouse may not be acceptable for use with joint credit (ECO Checklist question 6)

226.4(d) - The optional credit insurance disclosure indicates that insurance rates vary with the loan maturity and that the maturity is disclosed on the Credit Plan Advance Voucher. However, disclosure of the loan term on the voucher does not enable the member to determine the insurance rate before signing the authorization as required. The initial disclosure must contain all the information necessary for the borrower to determine the precise unit cost. (TiL Checklist question 5)

226.6(b) - If filing or non-filing fees are charged to the member in accordance with the security agreement, they must be disclosed or itemized on the initial disclosure as either a finance charge or other charge whichever is applicable. (TIL Checklist question 12)

OTS0050682D1 (1982) OE Voucher/SA

226.6(b) - If filing or non-filing fees are charged to the member in accordance with the security agreement, they must be disclosed or itemized on the initial disclosure. (TIL Checklist question 12)

OTS0060682S1 and OTS0070682S1 (1982) OE Voucher

No problems noted

## SRL Business System
Cherry Hill, NJ

SRL has developed a line of loan forms (loan applications, disclosures, etc.) for use with the insurance products of PHF Insurance Company. The forms are known as "Security Financial Plans."

| Form No. and Revision Date | Use of Form |
|---|---|
| Not assigned (1981) - Identified as OE Credit Life, Accident and Health | OE N/CI/TIL/AL-ECO |
| No problems noted | |
| Not assigned (1981) - Identified as OE Accident and Health only | OE N/CI/TIL/AL-ECO |
| No problems noted | |
| Not assigned (1981) - Identified as OE #2 | OE Request for credit advance |
| No problems noted | |
| Not assigned (1981) - Identified as CE Credit Life and Accident and Health - level premium | CE N/CI/TIL |
| No problems noted | |
| Not assigned (1981) - Identified as CE Accident and Health only - level premium | CE N/CI/TIL |
| No problems noted | |
| Not assigned (1981) - Identified as CE Credit Life and Accident and Health - single premium | CE N/CI/TIL |
| No problems noted | |
| Not assigned (1981) - Identified as CE Accident and Health only - single premium | CE N/CI/TIL |
| No problems noted | |

Not assigned (1981) - Identified as OE monthly premium outstanding balance loan programs	OE N/CI/TIL

226.4(d)(1) - Under these plans, the unit cost of the CDI will vary in relation to the corresponding term of the loan after the most recent advance. The form does not allow the member to identify the exact unit cost of the insurance without relying on information not contained on the disclosure or other document.
(TIL Checklist question 3)

## T.O.P., Inc.
Troy, MI

The T.O.P. loan forms were developed for use with the company's insurance products. The name of the administrative branch of this organization was recently changed to Creditor Resources, Inc. The product name is "Loan Pro."

| Form No. and Revision Date | Use of Form |
|---|---|
| 102 (5/82) | OE N/TIL, CI |

No problems noted

| | |
|---|---|
| LP 101 (5/82) | CE N/TIL, CI |

226.18(k)(2) - If prepaid finance charges are assessed, the form would have to be modified accordingly. (TIL Checklist question 24)

226.4(e) - If security interest charges (e.g., filing fees, nonfiling fees) are assessed, the form would have to be modified accordingly. (TIL Checklist question 24)

| | |
|---|---|
| LP 103 (5/82) | OE N/TIL, CI |

No problems noted

READEX FICHE

## 16. Conclusions - Total Analysis Process

One of the most important purposes of the examination is to guide the officials in building and maintaining a financially sound credit union. A total analysis of the overall financial condition must be made in order to accomplish this. All of the data collected during the examination is of value only if it is properly analyzed and plans for corrective action are developed when necessary.

Reserves, classified loans, the funds management program and operating ratios serve as a guide in evaluating the credit union's financial condition as of a given date. Recent trends, however, may have more significance than effective date statistical data. Other unmeasurable factors such as quality of management and economic conditions may also have a formidable impact on the credit union's situation and outlook. The examiner must take all of these factors into consideration in the total analysis process and most importantly, interpret them accurately. The examiner's objectives in reaching overall conclusions are to:

(1) Determine the credit union's ability to meet demands in the ordinary course of business;

(2) Determine the credit union's adherence to safe and sound practices;

(3) Formulate recommended action, when appropriate, based on the conclusions reached; and

(4) Communicate conclusions and recommendations both orally and in the examination report.

### 16.1 Total Analysis

Applying the total analysis process to financial analysis is a complex task. It requires that data be broken down into its component parts so that each part can be closely scrutinized. The examiner must then reassemble these parts into one package it from the standpoint of the content and quality of its parts, and the manner in which they fit together. Only after this is accomplished can the examiner expect to reach meaningful conclusions.

There are six steps in the total analysis process:

(1) Collect data;
(2) Review data;
(3) Interpret data;
(4) Reach conclusions;
(5) Make recommendations; and
(6) Formulate plans for action.

The examiner cannot perform a total analysis by methodically following these six steps. Some steps might be performed simultaneously with others, or even with other seemingly unrelated examination steps. However, it is necessary that each of the six steps be covered as the various areas of the examination are conducted.

The principles involved in the total analysis process should not be confined to analyzing financial condition. These principles should be applied when analyzing every area of credit union operations.

## 16.1-1 Data Analysis

In conducting the total analysis, the examiner must consider both statistical, or quantitative data, and non-statistical, or qualitative data. Both types must be accurate, valid and weighted for their relative degree of importance before a meaningful conclusion is reached.

The following is an example of how the consideration of pertinent qualitative data can virtually reverse a conclusion that was reached prematurely because only quantitative data was taken into account:

> XYZ credit union has a delinquency ratio of 70 percent and an expense to gross income ratio of 110 percent for the current year to date. The examination is made as of May 31. This is statistical data and is obtainable from information shown on the financial statements. Standing alone, it depicts an extremely unsatisfactory financial condition.
>
> During the course of the examination, the examiner learned that the employees of the sponsoring organization were on strike during the first 4 months of the year. Because most of the borrowers had not been making principal or interest payments on their loans during that period, delinquency rose sharply and very little interest income had been collected. Almost all of the borrowers are now back to work and on payroll deductions. The strike, the fact that it is over and the fact that most borrowers are now back to work and on payroll deductions are all examples of qualitative data that must be taken into account in the total analysis process. The ultimate conclusion that an examiner would reach in this case is that the credit union is not in as serious financial difficulty as is presented statistically.

## 16.1-2 Six Steps of Total Analysis

(1) Collect Data - Statistical data is collected during the fact-finding phase of each examination. The information is condensed on NCUA 2045, Examination Financial Data, NCUA 2046, Key Ratios, and other workpapers. Qualitative data is obtained by observation, reading the minutes and by discussion with officials and employees of the credit union during the examination and at the joint conference. This data is summarized on NCUA 2030, Examination Overview.

(2) Review Data - This step consists of breaking down and reassembling the data, relating the individual parts to the whole, noting the trends and weaving in the qualitative data. Four levels of depth are involved in the review:

a. Structural Analysis;
b. Trend Analysis;
c. Variable Data; and
d. Qualitative Data.

(3) Interpret Data - This is the most difficult phase of the total analysis process. The examiner's ability, judgement, experience and skill all come into play in this process. If inconsequential factors are given too much emphasis, and if significant factors are underplayed or ignored, the examiner will arrive at erroneous conclusions which could result in more harm than benefit to the credit union. Consequently, it is essential that the examiner:

a. Differentiates between important and unimportant data;

b. Places all the data in its proper perspective;

c. Observes the strengths and weaknesses of credit union personnel;

d. Is alert to what credit union employees and officials have to say;

e. Makes inquiries regarding the attitude of the sponsor, local economic conditions and other relevant factors not directly available within the confines of the credit union office; and

f. Observes the attitudes of the members who come into the credit union office to transact business.

(4) Reach Conclusions - After collecting, reviewing and properly interpreting all available data, reaching valid conclusions is a relatively simple matter. It is a natural by-product of the first three steps of the total analysis process. Since these conclusions will be translated into action during the next two steps, and since this action will have a significant impact on the course the credit union will follow in the future, the necessity for the conclusions to be accurate and logical is apparent. Thus, a breakdown anywhere along the line will negate most of the effort put into the analysis process.

(5) Make Recommendations - The recommendations made by the examiner are based upon the conclusions reached after having made the analysis. A recommendation is usually a general statement as to what should be done by the credit union to overcome its problems. A typical example of a recommendation is "The credit union should improve its collection procedures; thereby reducing uncollectable loans." This is a general, and no doubt a valid statement. However, unless a specific plan is set up, it is unlikely that the recommendation will be carried out. Therefore, the examiner must aid the officials in designing a plan for action which is the sixth step in the total analysis process.

(6) Formulate Plans for Action - A plan for action should specify at least who will take the action, how it will be taken and when it will be started and completed. Goals should be established and provisions for follow-up by an official or group of officials should be built in. The following is an example of a plan for action that might have been designed to carry out the recommendation referred to in item (5) above:

a. Establish a system to identify any loan on which a payment has not been made within 10 days of the due date. The chairperson of the supervisory committee will review this system by July 15 and make any needed suggestions for improvement.

b. Develop a series of three collection letters, with numbers two and three progressively firmer in tone. Submit the proposed letters to the board for approval by July 15.

c. Establish a specific time period for mailing each collection letter by August 1.

d. Review each loan on which a payment has not been received during the preceding 60 days. At each monthly board meeting, decide on whether or not to place the loan with a professional collector.

e. Charge off any loan delinquent 6 months or more, unless the last principal payment has been made within 60 days and was equal to at least 75% of the monthly payment called for by the note. During the annual audit, the supervisory committee chairperson will determine that such action has been taken.

The steps discussed above should remain in effect until both the examiner and the board agree that the financial condition has improved to the extent that the plan can be relaxed or is in need of strengthening.

Plans for action should be developed jointly by the examiner and the officials or key employees. While the examiner should have some definite plan in mind before approaching the officials on the subject, tact is needed if the plan is to be accepted. The examiner should be flexible and receptive to practical alternatives suggested by the officials. It is important that the officials understand that the plan is theirs, rather than one arbitrarily forced upon them by the examiner; the plan will more likely be implemented under these conditions.

Plans for action should be designed so that they will prevent problems from recurring, as well as to correct existing problems.

### 16.1-3 Four Levels of Analysis

Structural Analysis - Structural analysis is the technique of reviewing the component parts of a financial statement in relation to the whole. Thus, when it is said that the net income (loss) after dividends ratio is .4 percent of assets, a structural analysis ratio is quoted. The analysis is static in the sense that the analyst is reviewing the composition of the financial statement as of a specific date.

One of the important principles of financial statement analysis is that certain reasonable proportions should exist among the various items in the financial structure of the credit union. When one or more items attain an unreasonable proportion, the financial fabric can become strained. The structural analysis enables the examiner to spot these areas of strain, hopefully in time to prescribe remedial measures before a serious disruption takes place.

During this review, the examiner reviews the statistical data as of the effective date of the examination. This review is based, for the most part, on a number of structural ratios that must be calculated in order to complete NCUA 2046, Key Ratios. Generally, these are sufficient to appraise the credit union's overall financial condition as of the date of the examination. In some cases, however, other structural ratios may be needed to complete the analysis or to substantiate tentative conclusions that were reached after reviewing the required structural ratios.

Structural ratios should be reviewed individually and in relation to one another. It is important that all ratios be related to one another in order to determine the severity of the problem. For instance, if a credit union has a lower than normal operating expenses to assets ratio, the examiner's first impression might be that the credit union does not have an earnings problem. However, if the net income (loss) from operations ratio for the year to date is negative, the examiner should realize that earnings are a problem and a potentially severe one.

During this review, structural ratios can be compared between similar types and sizes of other credit unions, but must be done carefully. There are economic and geographical differences that preclude indiscriminate comparisons. The examiner should not use these data as standards or goals to be attained. Instead, a basic truism of ratio analysis should be kept in mind; ratios never answer questions; they only raise them.

The examiner should never recommend certain action either orally or in the examination report when the only reason that can be offered is to have the credit union meet a national average.

As mentioned earlier, the structural analysis enables the examiner to spot possible trouble areas; however, the structure approach is insufficient for the examiner to reach satisfactory conclusions and make sound recommendations. The indications of trouble are there, but the urgency and direction are yet to be determined. This requires a trend analysis.

Trend Analysis - Trend analysis is the technique of comparing the component part of a structural ratio, as discussed above, to itself over several periods. In this way, the changes in results of operations can be identified, questioned and evaluated. For example, assume a credit union has a ratio of delinquent loans to total loans of 25 percent. Assuming that this structural ratio was 15 percent at the time of the previous examination, the examiner would want to determine the reasons for the increase. To do this, the trends of each component should be reviewed, total loans and total delinquent loans. The increase may have resulted from any one of the following situations:

(1) Delinquent loans increased while total loans decreased or remained unchanged;

(2) Both delinquent loans and total loans increased, but delinquent loans increased at a faster rate;

(3) Both delinquent loans and total loans decreased, but total loans decreased at a faster rate; or

(4) Delinquent loans remained unchanged while total loans decreased.

When it is determined which one of the above situations apply, the examiner will be in a better position to continue the analysis. The application of the next two levels of review will be more meaningful.

To further highlight the significance of the trend review, let us assume that two credit unions are being examined in 1981 and both have shareholdings of $2,000,000. Upon applying the trend review, the examiner at Credit Union A noted that shares were $1,500,000 in 1986, and $1,000,000 in 1985. In Credit Union B shares were $2,500,000 in 1986, and $3,000,000 in 1985. Although the share statistics in both credit unions are identical, the trend review indicates that Credit Union A has no apparent problem in this area while Credit Union B's situation may be quite critical. The basis for these conclusions is that it is likely that Credit Union A's shares will continue to increase and Credit Union B's will continue to decrease. These projections are predicated upon the trend reviews and are likely to be fairly accurate unless significant changes are made. During the total analysis process, the examiner will need to ascertain what changes are needed to reverse unfavorable trends and to design recommendations and plans for action so these changes will be effected when the plans are carried out.

Application of Variable Data - Most balance sheet items consist of statistical variables which have an effect on the valuation of the balance in the accounts. Loans, General Ledger account 701, for example, is a statistic reflected on the balance sheet. In itself it provides little usable information in analyzing the credit union's financial condition. To analyze the account, it is necessary to know the statistical characteristics of the parts that make up the whole. Loans can be broken down in a number of ways. Some of these are:

(1) The amount current and the amount delinquent (the amount delinquent can be further broken down into length of delinquency);

(2) The amount collectable or uncollectable;

(3) The number of loans involved;

(4) The average unpaid balance of each loan;

(5) The loan turnover rate;

(6) The percentage of high risk loans which may be determined by profiling loans;

(7) The amount unsecured and secured;

(8) Among the secured loans, the amount secured by comakers, automobiles, real estate, etc.; and

(9) The appraised or market value of the security compared with the unpaid balances of the secured loans.

The first three of the above are determined during each examination. Under certain conditions, any or all of the remaining six may need to be determined in order to make a more meaningful analysis. Usually fairly accurate statistics can be compiled in respect to the latter through a sampling process rather than categorizing each loan on the records.

Some balance sheet items, such as cash and undivided earnings, do not contain variable characteristics.

A review of the variables is essential in the total analysis process. Its purpose is to look beyond the "static" balance sheet figures so that a more accurate assessment of the credit union's financial condition and quality of service can be determined.

Application of Qualitative Data - Qualitative data includes information and conditions that are not measurable in terms of dollars and cents, percentages, numbers, etc. Nevertheless, they have an important bearing on the credit union's current condition, and will undoubtedly affect it in the future. Examples of qualitative data encountered in credit unions are lending policies and practices, attitude and ability of the officials, collection policies and practices, economic conditions within the sponsoring organization and attitude of the sponsoring organization.

Some of these factors are beyond the control of credit union management. In those instances where they will tend to affect the credit union adversely, the examiner will need to work with the officials to develop policies or procedures that will counteract the unfavorable influences. Internal unfavorable influences must also, of course, be dealt with effectively.

As was the case with the trend review, the principal purpose of the review of qualitative data is to aid in projecting the credit union's future. Being able to predict the outcome to the extent that it is influenced by these immeasurable forces will enable the examiner to help develop more meaningful and practical plans for action in conjunction with the total analysis process.

Much of the in-depth review is performed during other examination steps; there is no set sequence for the gathering of qualitative data. However, before the results of the review are interpreted, all of the levels must have been covered.

### 16.1-4 Testing the Results

The results of the total analysis process can only be valid if the examiner considers all pertinent data, and if the interpretation is accurate. Recommendations will then be meaningful and plans for action can be designed to correct and prevent problems. If the total analysis process has not been applied properly, the recommendations and plans for action may not be appropriate. To reduce this possibility, the examiner should do the following before concluding the analysis:

(1) Make a quick, final review of all data;

(2) Determine that recommendations and plans for action are practical, specific and workable;

(3) Determine that they are understandable; and

(4) Determine that they will prevent problems from recurring.

### 16.2 Examination Financial Data, NCUA 2045

NCUA 2045, Examination Financial Data, is a key form for conducting the total analysis process. The workpaper is completed during each examination and included with the field copy and the regional office copy of the examination report. The form is designed to compile statistical data during the examination. Data necessary to compute the ratios on NCUA 2046, Key Ratios, is collected on this form. Instructions for completing NCUA 2045 are on the back of the form.

The examiner will first enter data for the current examination period in the right hand column. Data for the previous examination date or other date deemed more relevant by the examiner will then be entered in the left hand column. If a review of the collected data discloses adverse or unusual conditions or trends the examiner may extend the review by completing the middle columns for interim periods. The examiner may use whatever interim periods are most meaningful and easiest to collect the necessary data. The periods used will be clearly labeled at the top of each column.

When completed, the Examination Financial Data can be used to perform a short term trend analysis. A long term trend analysis can be made by comparing the current data to previous NCUA 2045s and by using the Financial Performance Reports (FPR).

Usually the amounts on NCUA 2045 will be identical to the information on the credit union's financial reports or NCUA 2050, Statement of Financial Condition, and NCUA 2051, Statement of Income. However, the examiner should use projected or pro-forma amounts when the examiner determines these amounts more accurately present the credit union's financial condition. An example of this would be a November examination of a credit union which closes it's books annually. In this situation, projected dividend costs and closing entries as of November would present a clearer picture of the financial condition. Any projected pro-forma amounts must be clearly footnoted on NCUA 2045. Also, workpapers detailing computation of pro-forma amounts should be included with examination workpapers.

The trigger items on NCUA 2045 will be answered after analyzing the data on the the form, reviewing the ratios on NCUA 2046, and considering other quantitative and qualitative information known to the examiner. A yes answer to any trigger item indicates examination procedures will be expanded in the area to determine if a major area of concern exists.

### 16.3 Key Ratios, NCUA 2046

Key Ratios, NCUA 2046, is completed for all examinations and included as part of the formal supervisory examination report given to the officials. Instructions for computing the ratios and for completing the form are on its reverse.

The ratios computed on NCUA 2046 allow an analysis of the major components of a credit union's assets, liabilities and equity accounts. These ratios focus on a major objective of the examination: evaluating solvency and profitability. The ratios are also used to determine if a major problem exists which would require additional examination procedures for proper analysis.

Many of the ratios on NCUA 2046 are also computed on the FPR. The ratios computed during the examination will be compared with the credit union's most recent FPR peer group average. The peer group average is only one means of evaluating performance. management strategy employed may cause a ratio to deviate from the peer group average yet still be acceptable performance for that credit union. Consideration must be given to all factors when analyzing the key ratios. The reasons or causes of a credit union's performance must be understood before effective recommendations can be made. Recommendations for change should not be made simply to allow the credit union to meet the peer group average.

### 16.3-1 Market Growth Ratio

The Market Growth Ratio is computed on NCUA 2046 and is also one of the 10 financial ratios evaluated on the FPR.

A credit union experiences real growth when the annualized market growth ratio exceeds the effective dividend rate. For example, a credit union with a market growth ratio of .5% is not experiencing real growth if the effective dividend rate is 6.75%. In this example the credit union has not even been able to retain the amount of dividends paid to members. Member share withdrawals have exceeded actual share deposits made excluding dividends.

Share growth is an indicator that a credit union is meeting the needs of the membership by offering competitive dividend rates and convenient service. Members often vote with their shares and a lack of growth may indicate dissatisfaction with services offered. Lack of growth may be related to other factors including unstable member employment, limited potential for new members, and a deliberate decision not to compete for certain types of shares. A lack of growth or an uncontrolled share decline could eventually affect the credit union's ability to support operating expenses, and ultimately affect continued viability.

Rapid growth may also be a cause of concern. Rapid growth is often related to expansion of services and staff. These changes can occasionally lead to administrative problems. A large growth ratio may also be caused by growth which is attracted by unreasonable dividend rates or share structures. The credit union may not be able to sustain these rates or structures over time and remain profitable.

The market growth ratio can be related to other key ratios on NCUA 2046, or to amounts on NCUA 2045. A market growth ratio in excess of the reserve change ratio indicates shares are growing more rapidly than retained earnings. This may be of little consequence if the spread is small. However, a large spread over time will result in a reduced capital ratio and reduced protection for member savings. Market growth ratios which are negative or extremely high will trigger further analysis.

### 16.3-2 Loans to Asset Ratio

The loans to asset ratio is computed during the examination and is included on NCUA 2046. The ratio is also computed on the FPR. The ratio and the peer group average are located on the page of the FPR which displays the 5-Year Ratio Analysis. The loans to asset ratio is located in the Balance Sheet Analysis Section.

There is no one correct loans-to-asset ratio. The same ratio can be good for one credit union and bad for another due to different share structures and loan types.

Loans are usually the largest asset category and often generate the highest return on assets. Since loans to members are a primary reason for the credit union's existence officials may well desire to maximize the amount of loans. However, maintaining a proper asset liability balance that provides adequate liquidity and will sustain profitability are also concerns that impact on the loans to asset ratio.

It is valuable to analyze changes in the loans to asset ratio between periods. Material changes in the ratio often indicate changes in loan policies and strategies. These changes should be controlled by management. Changes in loan types, share structure and membership employment should be considered when analyzing the loans to asset ratio. Material changes in the loan structure will trigger further analysis.

### 16.3-3 Loan Losses Ratio

The net loan losses to average loans ratio is computed during each examination, included on NCUA 2046 (Key Ratios) and is one of the ten key ratios computed on the annual FPR.

The examiner should be alert to increasing and/or high loan charge-off ratios that will assist in determining the scope of review to be conducted in lending policies and practices as well as the credit union's collection procedures.

In some instances a high ratio may also manifest itself in three other key ratios: Reserve Change, Capital and Net Worth. In applying the Total Analysis Process, the examiner should communicate the interrelationships of these key ratios to the overall financial condition of the credit union and their resultant impact.

### 16.3-4 Delinquent Loan Ratio

The delinquent loan ratio is computed on NCUA 2046, and is one of the 10 financial ratios evaluated on the FPR. The peer group average is located on the ratio analysis page of the FPR under the Loan Analysis Section.

The delinquent loan ratio is an indicator of delinquency control and potential losses on loans. Usually the higher the ratio the greater the potential for future loan losses. However, some credit unions continually have a high delinquent loan ratio without experiencing undue loan losses. Comparing the delinquent loan ratio to the FPR peer group average is one method of analyzing this ratio. When analyzing the ratio consideration should be given to the credit union's charge-off policy and loss ratio. The credit union's ability to absorb loss must also be evaluated.

It is usually most valuable to compare the credit union's current delinquent loan ratio to the credit union's delinquent loan ratio for previous periods. An increasing delinquent loan ratio often indicates increased future loan losses. The cause of an increased ratio may be weakened loan policies, poor collection practices, adverse member employment or other conditions.

A high delinquent loan ratio can be further analyzed by considering the age of the delinquent loans. If the majority of delinquent loans are in the higher age categories (6-12 months and 12 months plus) the condition is probably more serious then if most delinquent loans are in the 2-6 month category.

The delinquent loan ratio can also be compared to other key ratios. A slightly high delinquent loan ratio will be of more concern when the credit union has a low capital ratio and/or a negative reserve change ratio.

A material increase in the delinquent loan ratio will trigger further analysis to determine the cause of the trend and the seriousness of the condition.

### 16.3-5 Retained Earnings Change Ratio

The retained earnings change ratio is computed during examinations and is included on NCUA 2046.

A positive retained earnings change ratio is indicative of profitable operations. Likewise, a negative ratio indicates unprofitable operations. An annualized negative ratio can be used to roughly project when a credit union will deplete its retained earnings if circumstances remain unchanged.

> Example: The retained earnings ratio is a negative 30 percent. Dividing 30 into 100 equals 3.33. This indicates retained earnings will be depleted in 3.33 years if conditions are unchanged.

A negative retained earnings ratio is cause for concern but may have been caused by an unusual non-operating loss, a large increase in the Allowance for Loan Losses, or the situation causing the loss may already be corrected. Regardless, a negative retained earnings change ratio will trigger further analysis to determine the cause(s) of the condition.

The main consideration in analyzing the retained earnings change ratio will be to determine whether the ratio is positive or negative. The size of a positive retained earnings change ratio will usually reflect the management philosophy of officials. Some examples of management philosophy which may be reflected in the ratio are: relating growth of retained earnings to growth of shares (market growth ratio), average rate of dividends paid on shares, rate of growth in total assets, or effective yield on assets to name a few.

The retained earnings change ratio measures the percent increase or decrease in retained earnings. Management may have differing goals for a credit union's performance and the level of retained earnings. The retained earnings change ratio should be consistent with these management goals. Examiners should not impose their personal opinions on management. However, maintaining adequate retained earnings and positive trends in these accounts should be a goal of sound management.

### 16.3-6 Capital Ratio

The capital ratio is computed during examinations and is included on NCUA 2046. The ratio is the same as the capital ratio computed on the FPR. The peer group average is located on the ratio analysis page of the FPR under the Balance Sheet Analysis section.

The capital ratio relates retained earnings plus shares to total shares. The ratio does not consider unrecorded or potential losses, but is a measure of the credit union's ability to absorb losses. Similar ratios have historically been one measure of a financial institution's financial strength. A ratio higher than the peer group average indicates that the credit union has a better ability to absorb loss than the average credit union in the peer group.

In analyzing the capital ratio consideration should be given to the degree of risk involved in the operation. A low ratio may not be a large concern for a credit union with stable member employment, a high quality loan portfolio and few concentrations of credit. Conversely, a low capital ratio may cause concern if the credit union is involved with high risk operations such as commercial loans or large concentrations of credit.

The capital ratio should be stable or increasing over time. The ratio measures the ability to sustain losses should they occur. Officials should be informed of their credit union's capital ratio trends but advised to increase retained earnings only when retained earnings are insufficient for the needs of the credit union.

### 16.3-7 Net Worth Ratio

The Retained Earnings to Total Assets ratio is computed during each examination, included on NCUA 2046 (Key Ratios) and is computed on the FPR.

The Net Worth ratio measures the accumulated equity generated by the credit union and its relationship to total assets. An increasing ratio is an indicator of financial strength. Conversely, a low or decreasing ratio can be cause for concern and should trigger additional analysis.

This ratio, a standard performance menasurement used by the corporate and financial industry, represents a key indicator of solvency. All credit unions should be encouraged to establish Net Worth Ratio goals for future years. Subsequent examinations should track credit union performance against these established goals as well as the industry averages.

### 16.3-8 Personnel Expenses Ratio

The Personnel Expenses ratio is computed during each examination, included on NCUA 2046 (Key Ratios) and in one the ten key ratios on the FPR.

This ratio measures the percentage of gross income allocated to personel expenses, the largest category of expenses, and is a critical factor in overall operating expense control. An increasing or high ratio can be one indicator of operational inefficiency. Such high ratios may trigger a need to encourage management to evaluate procedures, programs, staffing and personnel to assure improved operational productivity.

### 16.3-9 Yield on Assets

The yield on assets ratio is the same as the first ratio (yield on average assets) under section V, Management Analysis, on the ratio analysis page of the FPR. The ratio is computed during examinations, annualized as necessary, and is included on NCUA 2046, Key Ratios.

The yield on assets ratio measures how the credit union utilizes its resources (assets) to produce income. It is a good indicator of the income producing ability of assets. For example, management decisions to minimize investments in non-income producing assets often results in a higher yield on assets. In addition, management policies on interest rates for loans and investment policies will affect the yield on assets.

The yield on assets ratio measures income as a percentage of average assets. A low yield on assets could be a contributing factor to a credit union experiencing operating losses. A high yield is not necessarily desirable as it may be due to excessive loan rates or a need to cover high operating costs which are inefficient.

Analysis of the yield on assets ratio becomes critical when the credit union is experiencing operating losses as indicated by negative net income ratios.

### 16.3-10 Cost of Funds to Assets Ratio

The cost of funds to assets ratio is the same as the cost of funds/average assets ratio on the ratio analysis page of the FPR. The ratio is computed during examinations and is included on NCUA 2046, Key Ratios.

This ratio relates both dividends on shares and interest on borrowed money to average assets. There is no "right" cost of funds to assets ratio due to the many factors, both internal and external, influencing the cost of funds to individual credit Unions. However, the cost of funds is a critical element in the overall profitability of operations.

External influences on the cost of funds include competitive factors such as rates paid by other financial institutions in the area. These factors cannot be controlled by credit union management.

The cost of funds to assets ratio is not the same as the effective dividend rate on shares. However, this ratio will allow a comparison of the cost of funds between credit unions. A cost of funds to assets ratio in excess of the peer group average means the credit union's cost of funds (possibly dividends) is higher than the average credit union in the peer group.

Since a high cost of funds may mean higher dividend rates to members, a high ratio may be desirable. However, since high costs of funds may adversely affect profitability, the overall costs of funds must be controlled.

As with other income and expense ratios, analysis of the cost of funds to assets ratio is critical when the credit union is experiencing operating losses. When high costs of funds are coupled with operating losses the examiner should determine if the cost of funds is so greatly influenced by competition that it is not within the complete control of management. If so, it may be necessary to make changes other than in dividend rates to return the credit union to sound operations. When improvements in other aspects of operations are not possible, or cannot be made immediately to eliminate losses, the officials must consider lowering the cost of funds by whatever means are available to maintain solvent operations.

### 16.3-11 Operating Expenses to Assets Ratio

The operating expenses to assets ratio is the same as the Operating Exp less Int & PLL/Aver Assets Ratio on the ratio analysis page of the FPR. This ratio is computed during the examination and is included on NCUA 2046, Key Ratios.

This ratio relates operating expenses minus the provision for loan loss expense and interest on borrowed money expense to average assets. The ratio measures how efficiently the costs of operation are controlled. There is no one "right" operating expense to asset ratio because many factors, including sponsor support and services offered, impact on this ratio.

The operating expense to assets ratio may be analyzed and compared with the peer group average contained on the FPR. A national average should not be used as a goal, but as a means of determining the control of operating costs. It is usually more valuable to review the ratio's trend over time for the individual credit union. A gradual decrease in the ratio would indicate increased efficiency or relative reduction in operating expenses compared to assets. Conversely, an increase in the ratio may mean reduced efficiency or the addition of services which are not presently cost efficient.

Analysis of the operating expense to assets ratio becomes critical when the credit union is experiencing operating losses indicated by negative net income ratios. A rising or high operating expense to asset ratio coupled with operating losses indicates a need to reduce, or to better control operating costs.

Using assets as a basis for analyzing expense control is more desirable than using income because assets are a more stable and consistent base for measurement. Income is subject to significant short-term changes in loan and investment rates. Assets are a more reliable base particularly in a period of rapidly changing rates of return on assets. Income does not provide a consistent base for measurement between credit unions due to the differing loan rates and yield on assets. Relating operating expense to income is a means of measuring cost efficiency, but relating expenses to assets is the preferred analytical tool.

### 16.3-12 Net Income (Loss) After Dividends to Assets Ratio

This ratio is the same as the Net Inc before Trans to Stat Res/Aver Assets Ratio on the ratio analysis page of the FPR. The ratio is computed during examinations, annualized as necessary and is included on NCUA 2046, Key Ratios.

The net income (loss) after dividends-to-assets ratio measures net income to average assets without regard for reserve transfers required by law. As with most ratios, there is no one correct percentage. The most important consideration is that the ratio should be positive. A positive ratio would indicate that retained earnings are increasing. Comparison to the peer group average makes it possible to determine how a credit union is performing compared to a national average. However, encouraging increased earnings just to meet a national average should be avoided.

A negative ratio is cause for concern. The cause of the negative ratio should always be determined. A negative ratio could be caused by too low a yield on assets, excessive operating costs or cost of funds, an unusual non-operating loss, or a combination of these factors. Analysis of the ratios related to these areas will be most important when either of the net income ratios is negative.

Although this ratio does not measure the absolute "bottom line," it is a valuable tool in that it can be related to a national average and is not skewed by varying reserve transfer positions.

### 16.3-13 Net Income (Loss) From Operations to Assets Ratio

This ratio is not computed by the FPR. The ratio will be calculated during examinations, annualized as necessary and will be included on NCUA 2046, Key Ratios.

This ratio compares the "bottom line" Net Income (loss) from operation (as shown in NCUA 2045, Examination Data) to average assets. It considers all sources of income and all uses of income, including net reserve transfers, to arrive at the percentage of assets that is profit.

Only required reserve transfers will be considered for the purposes of this ratio. Voluntary transfers to the regular reserve will be disregarded. Also, the net reserve transfer will not be allowed to be negative when the provision for loan losses expense exceeds the regular reserve statutory transfer.

A negative net income (loss) from operations to assets ratio is cause for concern as it indicates a loss on operations after all factors, including reserve transfers, are considered. Officials must be made aware that such a condition cannot be allowed to continue uncontrolled. Again, there is no correct ratio, but the ratio should be positive unless there is good reason to deplete retained earnings and temporarily operate at a loss.

This ratio can be used to measure the severity of the problem. That is, the larger a negative ratio the more severe the problem. The ratio can also be used to make rough projections.

> Example: A $1,200,000 credit union with $20,000 in Undivided Earnings has consistently had a negative net income (loss) from operations to assets ratio of 1.1 percent. The projected loss for the next 12-month period can be determined by multiplying $1,200,000 x .011, resulting in a projected loss of $13,200 (if conditions remain unchanged). At that rate, the credit union's $20,000 in Undivided Earnings will be depleted in 1.5 years ($20,000 ÷ 13,200 equals 1.5). Of course, if the ratio had been steadily declining (i.e., the rate of loss is accelerating), Undivided Earnings will probably be depleted sooner unless the problem is corrected.

This ratio will also give some indication of how much improvement is needed in operations to break even. Gross income, operating costs, cost of funds, non-operating gain or loss and net reserve transfers are component parts of net income. In the example above gross income would need to increase or the other factors decrease by a combination of 1.1 percent of assets for the credit union to break even. The component parts should be analyzed and qualitative data considered to develop a plan of action.

Analyzing profitability is a critical part of the examination process. Examiners should always attempt to determine that future operations will be profitable. Therefore, adverse trends in the net income (loss) from operations to assets ratio will always be closely analyzed. Future changes in services offered and general operating conditions must be considered when analyzing this ratio.

It is possible for the net income (loss) from operations to assets ratio to be positive despite the fact that statutory reserves and total retained earnings are declining. This condition would be signaled by a negative reserve change ratio. This condition could be caused by the charge off of uncollectable loans.

### 16.3-14 Optional Ratios

Sections 9 and 10 on Form NCUA 2046 (Key Ratios) are provided for the examiner to include additional ratios believed to be significant in evaluating financial performance. A number of other ratios or averages with corresponding FPR peer group averages are available for use. Examples are:

Classified Loans/Retained Earnings
Nonearning Assets/Total Assets
Borrowings/Reserves, Undivided Earnings and Shares
Dividends/Gross Income
Salary & Benefits/Full-Time Employees

In addition, the examiner may wish to include the Probable Asset Share (PAS) ratio when it is significantly less than the Capital ratio. Since this figure is an examiner-generated ratio, there will be no appropriate "peer" average to include on the workpaper.

### 16.3-15 Ratio Analysis

In analyzing financial condition, examiners must consider all factors including qualitative data that would only be available to the on-site observer. Examiners should not focus on just one ratio while forgetting other key ratios. The cause of adverse ratios and future prospects are always more important than the ratios by themselves. Ratio analysis does not answer questions and resolve problems; it only raises questions and problems. However, proper use of ratio analysis is essential to the examination process.

### 16.4 Communicating the Results

The examiner will communicate the results of the examination during the joint conference or the exit interview and in the Supervisory Examination Report, which are discussed in sections 17 and 18, respectively.

### 16.5 Workpapers and References

(1) Workpapers

a. NCUA 2010, Examination Input
b. NCUA 2045, Examination Financial Data
c. NCUA 2046, Key Ratios
d. NCUA 2047, Asset Share Ratios
e. NCUA 2030, Examination Overview

## 17. Joint Conference

The examiner will meet with the board of directors for a joint conference at the conclusion of every examination of a credit union rated EWS Codes 3, 4 or 5. The credit and supervisory committee chairpersons and key staff personnel should be invited to attend. To a larger extent the data developed during the examination is used for instruction of staff as well as officials. A well performed examination loses much of its effectiveness unless the joint conference produces positive agreements with the people who will implement the plans for corrective action.

### 17.1 Optional Joint Conference

If the credit union is assigned an EWS Code "1" or "2", a joint conference is optional. However, if the officials request a joint conference and/or the examiner believes that a joint conference is necessary regardless of the EWS Code, a conference may be held. Travel and per diem costs should be considered when making this decision. If a joint conference is not held, the examiner will hold an exit interview with those persons needed for discussion of key topics. At a minimum, the president, the treasurer, and the supervisory committee chairperson should attend.

### 17.2 Conference Objectives

The examination should have been completed, or nearly so, by the time of the joint conference. The examiner should have a fairly detailed knowledge of the credit union's operations, its weaknesses, its strengths, and its needs in order to effectively communicate the examination findings to the officials and to assist management in developing plans for corrective action.

If a team examination has been performed, the Examiner-in-charge may find it beneficial to include those examiners who are most familiar with the specific problem areas which will be addressed.

The objectives of a joint conference are to:

(1) Foster a better understanding of the respective roles of officials and examiners;

(2) Inform the officials of the examination scope and the credit union's condition;

(3) Reach agreements to correct problem areas; and

(4) Inform officials of needed corrective measures when they are unwilling to agree to recommend steps in a plan for action.

The Examiner-in-charge should meet with the president as early as possible in the examination to make arrangements for the joint conference. Emphasis should be placed on the importance of the joint conference and of attendance by as many officials as possible. If the examiner learns that the conference will be poorly attended or encounters problems that may extend the examination time, the conference should be rescheduled. Attempts should be made to avoid excess travel costs and examination time; however, these should not be the primary considerations in credit unions with serious problems.

The joint conference should be conducted in a business-like manner and in an atmosphere that will promote clear, understandable communication between the examiner and the officials. Meetings must be constructive. Detailed preparation is necessary to accomplish that end. The success of the joint conference depends on the substance of matters discussed and the effort the examiner puts forth.

It is imperative that the examiner deal with factual data only and not attempt to answer questions for which complete and accurate answers cannot be provided. When in doubt, the examiner should inform officials that their questions will be presented to the regional office and that an answer will be forthcoming.

The examiner should be careful to ensure that comments are not misconstrued by officials, and should refrain from making broad, general statements that could be misinterpreted.

Officials should be advised to prepare minutes of the joint conference to avoid misunderstandings. Many credit unions now use tape recorders at the joint conference and they usually ask for the examiner's approval. The examiner should normally not object to the use of these devices. The examiner may wish to request that a copy of transcript be sent to the examiner to ensure that the officials have accurately interpreted the examiner's comment and have understood the agreements reached.

All agreements, understandings and target dates should be specific and assignments for corrective action should be clearly understood by the persons involved.

## 17.3 Agenda

Meetings with officials must be conducted in a clear, concise, and orderly manner. The examiner should prepare a detailed agenda that covers matters to be discussed and the objectives to be reached. The agenda should be included with the workpapers submitted to the regional office.

An agenda will help to ensure that all pertinent data is presented in a logical order. Therefore, it should be finalized until all the facts have been gathered and analyzed. In preparing the agenda the examiner will have another opportunity to week out the non-essential material so that emphasis can be confined to material items. The examiner should ensure that officials are able to distinguish between minor and major problems.

The agenda is merely a starting point for the joint conference. Supportive data should be prepared and organized so that the information is presented in a professional manner. Comparative figures and ratios from the previous and present examinations, which indicate adverse trends, should also be prepared prior to the conference. It is important for the officials to realize that the examination is more than an audit of one moment in time. Instead, the examination is a financial and managerial analysis of where the credit union came from, where it is now and where it is headed.

## 17.4 Pre-Joint Conference Preparation

It is courteous and productive to discuss the agenda topics and material problems with the manager and key officials prior to the joint conference. A discussion of this nature can serve to elicit their cooperation and support as well as to eliminate or reduce potential conflicts which might occur at the joint conference. In order to maximize the effectiveness of the joint conference, the examiner-in-charge should resolve problems of a minor nature with the manager or treasurer prior to the meeting. Also, it is effective to start formulating corrective plans for action with key officials prior to the joint conference.

To aid clear understanding examiners may use a "working copy" of records of action at the joint conference. This working copy should only be used to promote better understanding and discussion. Officials must be involved in developing corrective plans for action if the plans are to be effective and implemented. The examiner must be willing to adjust or revise any recommendation during the joint conference. Examiners should not dictate credit union policy, but rather lead and persuade officials to proper action.

## 17.5 Conducting the Joint Conference

The effectiveness of the joint conference is directly related to the extent to which communication is established and to which the examiner maintains credibility. Therefore, as in every other contact with a credit union, it is essential that the examiner's conduct remain dignified, professional and objective while remaining sensitive to the fact that officials are often unskilled volunteers who need encouragement as well as positive criticism as the situation dictates. The examiner should discuss major relevant points and present that information needed to accomplish the agreed upon objectives.

The following are guidelines that should help the examiner to plan and conduct a joint conference more effectively:

(1) Establish rapport with officials early in the conference. A principal objective of the examination is to aid officials in fulfilling their goal of having the credit union serve its basic purpose.

(2) Compliment the officials for specific achievements and for their volunteer time, if this is appropriate.

(3) Encourage two-way communications. Ask questions frequently to be certain that statements are understood. Invite officials to participate freely in the discussions.

(4) Present material in a logical sequence. The presentation should be constructive and positive. Merely citing the problem will rarely stimulate action, so offer to assist officials in devising corrective and preventative plans for action.

(5) Present the formal copy of the examination report to the chairperson of the board. Many examiners have found it useful to provide all officials and staff at the joint conference with photocopies of the same packet of information. Such distribution provides for "full disclosure" to credit union management of NCUA's assessment of their performance.

(6) Urge the officials to make firm commitments for implementing the plans for action. They should be made a matter of record in the board minutes.

(7) Review all the agreements reached with officials at the conclusion of the conference.

### 17.6 Other Persons Present

Since the matters discussed at the joint conference are confidential, the examiner may be inhibited when persons other than credit union officials and employees are present. However, officials may wish to invite other persons. When this occurs, the presiding officer should advise all officials that they are taking full responsibility for disclosure of any confidential information that may result from the presence of outsiders. If any official objects to an outsider and the issue cannot be resolved, the examiner should postpone the meeting until a later date. If the examiner objects to the attendance of any outside individual, the examiner should consult with the Supervisory Examiner for guidance. If the Supervisory Examiner concurs with the examiner, the examiner should review the situation with the president. If the president cannot or will not resolve the problem, the meeting should be rescheduled and a memorandum prepared outlining the problems. The key to avoiding such conflict is to determine who will be attending the joint conference in advance.

## 18. Supervisory Examination Report

The Supervisory Examination Report is NCUA's official report to a credit union on the examiner's findings during an examination. The report is prepared in final form by the Examiner-in-charge and in most cases is left with key officials at the conclusion of the examination. The official report serves as an important communication channel between the examiner, the credit union and regional office. The credit union officials are intended to be the primary users of the report. It is important, therefore, that the report be written to the officials and not to the regional office. The examiner should provide appropriate instructions to the officials so that they fully understand how to use the report. It should fully document all problems and any agreements reached, as well as provide officials with guidance and management information. Forms and schedules included in the official report should be prepared in a professional manner as it will reflect the image of the examiner and NCUA.

The Supervisory Examination Report should present in writing the financial condition, trends, problems, agreements and guidance which the examiner expressed to the officials orally. By presenting the official report to the officials at the conclusion of the examination, there should be little disagreement as to what transpired during the examination. There should be no surprises to the officials. If items are significant enough to include in a written report, they should be significant enough to discuss with officials and key operating personnel. The opposite also is true; i.e., significant comments and recommendations made orally during the examination should be contained in the official report.

In addition to the official report, there are two other reports prepared during the examination. One report is for regional office use and is an exact duplicate of the official report, except that it includes a copy of NCUA 2141, Closed Section. The other report is for examiner use and includes copies of the official report plus all workpapers, schedules, checklists, forms and examiner-prepared notes taken during the examination in support of the official report.

There may be an instance when the examiner elects not to leave the official report with the credit union at the conclusion of the examination. The examiner may wish to have the Regional Director review and endorse the report prior to release because of the controversy of the subjects treated in the report or the sensitivity of the issues.

In such cases, the examiner, after discussing it with the Supervisory Examiner, will forward the entire report to the regional office. A memorandum will be attached explaining why a formal report was not left with the officials and instructing which forms and workpapers should be included in the official report. The official report will be typed and either released by the regional office or sent to the examiner for delivery to the credit union. The regional office will confer with the Supervisory Examiner on material changes to the report as a result of the review.

### 18.1 Components

Core examination workpapers (refer to section 1.3) form the basis for the Supervisory Examination Report. In well-operated credit unions, they usually are the only forms included in the report. The examiner should use discretion and add only forms and workpapers that support examination findings to the report. Supporting forms and workpapers can be examiner-designed as well as supplemental NCUA forms.

Additional forms and workpapers in the examiner's report should adequately disclose the nature and extent of worked performed by the examiner. The workpapers should support the review and appraisal by the regional office and by the supervisory examiner.

### 18.1-1 Assembly

Most forms and workpapers that would be included in the Supervisory Examination Report and left with the officials are in micro-encapsulated sets. Unless otherwise noted, the white copies are for use in the official report; the yellow copies are for the examiner's report; and the pink copies are for the regional office report. All three reports (officials', examiner's and regional office's) will be assembled in form number order. Examiners are requested to separate the pink and yellow copies before the workpapers are submitted to the regional office. The pink copy should be stapled and placed on top of the examiner's copy.

If the credit union's financial statements are used in lieu of NCUA forms 2050, Statement of Financial Condition, and 2051, Statement of Income, they will be inserted where the NCUA forms would have been placed in the report to the officials and in the regional office's and the examiner's copies. If the examiner cannot make a copy for the regional office, the examiner should include a route slip instructing the regional office to make copies. All examiner-designed workpapers will follow the NCUA forms, unless insertion elsewhere serves a useful purpose.

Unless instructed otherwise, the examiner will submit the report to the regional office with all three copies of NCUA 2010 on top, followed by the stapled regional office copy (pink) and then the examiner's copy (yellow). The regional office copy and the examiner's copy will be identical to the copy left with the credit union officials, except for inclusion of the Closed Section.

### 18.2 Examiner Contact Information, NCUA 2010

NCUA 2010, Examiner Contact Information, is used to update NCUA's data base on information compiled during examinations and follow-up examinations and for entering corrections. The form is completed during all examinations according to instructions on its reverse and is enclosed intact on top of the examination report submitted to the regional office or Supervisory Examiner.

This three-part form is distributed by the regional office or examiner in the following manner:

(1) White copy - Regional Office.

(2) Pink copy - Supervisory Examiner.

(3) Yellow copy - retained by examiner.

### 18.3 Supervisory Examination Report (folder), NCUA 2020

NCUA 2020, Supervisory Examination Report (folder), is used to retain the official examination report presented to the credit union. The inside of the folder includes an area for the receiving official to acknowledge receipt of the report and for all officials to certify that they have reviewed its contents.

### 18.4 Examination Overview, NCUA 2030

NCUA 2030, Examination Overview, will be completed during each examination. It is intended to summarize the examiner's review, analysis, and findings in major areas of the credit union's operation, financial condition, and management. Comments should be kept brief. Also, since the examiner's review in a particular area might have been limited because no existing or potential problem was apparent, comments in these areas may be general (e.g., trends positive, policies adequate, etc.).

The Examination Overview should be completed near the end of the examination. Preferably, it should be completed prior to the joint conference or exit interview. If additional information is learned at or after the joint conference which would affect or add to the content of the report, the examiner may add addendum comments. Sufficient space has been provided for this purpose.

One or two problems in an area do not necessarily mean that the area is of major concern. On the other hand, one exception may be so serious that the examiner believes the matter is a major problem and that formal Record of Action treatment is necessary. Corrective action for minor exceptions may be indicated in the comments section of the Examination Overview workpaper. However, when the examiner determines that a problem is a major area of concern, the plan for corrective action developed with the officials will be documented in a Record of Action. The Examination Overview may/should discuss the area of concern and lead the officials to the Record of Action section of the report. A major area of concern is defined as a problem area that could seriously affect the safety and soundness of the credit union or which could seriously interfere with the normal daily operation.

When a problem area is encountered, it may be necessary to expand the analysis to determine the severity of the problem and possible corrective action. In these instances, the examiner should complete whatever workpapers are necessary to properly analyze the problem. Any workpapers referenced in the Examiner's Guide or examiner-designed workpapers may be used. Workpapers prepared may be included in the report to the credit union. Examiners must be aware of the need to document and support the analysis of problem areas and the conclusions reached.

### 18.5 Record of Action, NCUA 2035

NCUA 2035, Record of Action, is used to document agreements reached with officials to correct major areas of concern. Instructions for its completion are on its reverse, but an additional discussion follows.

It is expected that the examiner will work closely with the officials in developing plans for action to resolve the areas of concern. Detailed plans for action are especially critical for resolving financial problems in credit unions coded EWS 3, 4 or 5. If the examiner believes that a financial problem (delinquency, profitability, funds management, etc.) will cause a credit union to become insolvent or to require special assistance within the next 18 months, the plans for action to deal with the problem areas must give the officials specific direction to correct the problems. Adequate supervision and direction, including specific and detailed plans for action, must be provided to the credit union officials before the credit union needs special assistance or becomes insolvent.

At times, the officials will not agree on a plan for action to resolve a problem or that a problem even exists. The examiner must make every effort to ensure that the officials understand that there is a problem. If the officials do not agree with all or part of a plan for action, the examiner may consider drafting a letter for the Regional Director's signature documenting the officials' need to recognize and to resolve the problem area. Plans documented on the Record of Action should be asterisked and the form footnoted to show that the plan described was not agreed upon, but that it is nevertheless being recommended for adoption. If appropriate, the officials should be instructed to submit a plan of their own to the examiner. This instruction can be in the form of a footnote to the Record of Action or as an added step to the Record of Action. Examples of typical footnotes are on the reverse side of the form. The Closed Section should include comments regarding lack of adoption.

Examiners should be aware of the relationship between Examiner's Findings and the Record of Action. The findings cite the violation, for example:

> "The treasurer has not maintained full and complete records of officials' and employees' travel expenses as required by Article VIII, section 5(c) of the Bylaws."

The Record of Action documents the agreement reached with the officials to correct the problem. In those instances where an EWS code 2 is assigned but no Record of Action is prepared, the examiner will document agreements reached with the officials in other portions of the open section of the report. Because plans for action are prepared for major areas of concern, there can be Examiner's Findings that do not have plans for action, i.e., minor areas for which a Record of Action is not needed. Because plans for action are corrective agreements, there can be major areas of concern that do not have Examiner's Findings prepared to list a violation, i.e., a rising delinquency rate. In most cases, it will not be necessary to provide a reference in the Record of Action because the reference is given in the Examiner's Findings.

### 18.6 Supplementary Facts, NCUA 2036

NCUA 2036, Supplementary Facts, is used to discuss material facts or situations not contained in other narrative sections of the Supervisory Examination Report.

The information will be prepared for presentation to the officials. The examiner should use headings to separate each topic. To improve readability for the officials, the examiner may choose to number paragraphs. Facts should be stated as distinctly as possible. As in other open sections of the report, the examiner should avoid opinions or comments based on gossip and hearsay.

Specific instructions for completion are located on the reverse of the form. If there is no need to prepare the Supplementary Facts, the form will not be included with the workpapers.

### 18.7 Examiner's Findings, NCUA 2115

NCUA 2115, Examiner's Findings, will be used to list operating exceptions, violations of law or regulation, and/or unsafe and unsound policies, practices, and procedures. It should be prepared neatly, written in complete sentences and be grammatically correct.

Relatively minor, infrequent infractions should not be listed since they will detract from the more important matters that need to be given attention. These minor items can usually be resolved through oral discussion with the appropriate officials.

The examiner should cite the specific section of the Act, Bylaw, Rules and Regulations or other authority that is being violated. In the event that more than one of the above is being violated, the examiner should cite the highest authority. Space is provided to allow the examiner to cite additional references, if appropriate.

Exceptions that were also listed during the previous examination should be noted by either listing them on this workpaper under a heading similar to: "Findings Noted at Previous Examination Which Are Not Yet Corrected" or by placing an asterisk next to the exception and by including a footnote with similar wording. Particular emphasis should be made by the examiner to the officials to assure that these exceptions are corrected.

The examiner should determine that as many exceptions as possible are corrected prior to the completion of the examination. When corrections have been made or when agreements for correction have been reached, a check mark will be placed in the appropriate column on the form. The workpaper also contains a column in which the examiner will indicate with whom each item was discussed. The symbols at the bottom of the form will be used for this purpose.

Specific instructions are provided on the reverse side of the workpaper.

### 18.8 Closed Section, NCUA 2141

NCUA 2141, Closed Section, is for NCUA's internal use only. However, there are situations when a court can direct that all or part of a particular Closed Section be released. Further, some parts of a Closed Section may be released in compliance with a Freedom of Information Act request. The possibility of release should not dissuade examiners from presenting any of the information requested by the instructions on the form's reverse side; however, examiners should maintain their professionalism and objectivity when writing the Closed Section.

The Closed Section is important to the regional office and to the next examiner to determine how the objectives of the examination are being achieved. It should supplement the information given elsewhere, not reiterate what is already stated in the official report.

The important corrective and constructive work accomplished during the examination should be reported in the Closed Section if not included in the open section of the report. In instances where there is no need for additional information, the examiner can simply state "none" on the form. The comments should be brief but complete enough to clearly show what action was taken. To merely state that certain matters were discussed adds little, if anything, to the report. Of particular importance is an explanation of what was accomplished during discussions with officials. If not elsewhere in the official report, the Closed Section should state what formal actions were taken by the board and how the major problems will be dealt with. Agreements reached with officials, not commented on in the Record of Action section of the formal report, also should be recorded.

The Closed Section should be clear, complete and concise. Above all, it must be readable. Lengthy, detailed discussions should be avoided. Appropriate topical headings should be used to improve readability and facilitate quick reference. The Closed Section, if typed, should be single spaced; however, double spacing between topics should be used. Areas which may be appropriate to comment on appear on the reverse side of the form.

Pertinent matters of a private or restricted nature and personal opinions based on the examiner's observations should be included in the Closed Section. However, the examiner should be careful not to make statements that are based on gossip or hearsay. An appraisal of a new credit union's prospects, comments concerning the attitudes and abilities of the officials and difficulties that may be facing the credit union in the future are examples of the types of material to be presented. The Closed Section should be used as extensively as necessary but not be cluttered with facts or opinions that are inconsequential and/or irrelevant.

The examiner should conduct each examination in such a manner that follow-up examinations will not be necessary. However, follow-up examinations usually will be made at credit unions assigned EWS Code 4 or 5. In other instances, conditions such as serious violations of regulations or a critical or deteriorating financial condition may indicate the need for a follow-up examination. In these cases, the plans for follow-up should be included in the Closed Section.

### 18.8-1 Recommendations

(1) Recommendations for Submittal of Periodic Reports: There may be times when the examiner believes there is a need to monitor the performance of a credit union during the period between examinations. An example would be a credit union showing adverse profitability ratio trends, although not yet at a critical point. The examiner may request the credit union to provide a copy of the monthly financial reports, thus enabling a review on a continuing basis. The examiner's plans for requesting such reports should be stated in the Closed Section along with the reasons for doing so. In keeping with the total district management concept, such reports should be forwarded directly to the examiner by the credit union. Only under unusual conditions will the examiner recommend that such reports be submitted directly to the regional office (such conditions might occur when an examiner is on an out-of-region detail, working in a vacant district, or when the regional office has requested direct input on a specific issue).

(2) Recommendations for Preliminary Warning Letters: In most cases leading to an administrative action, the credit union, as a standard practice, will be forwarned by letter from the Regional Director that unless correction of the persisting problem(s) occur(s) or reasonable progress is made toward the elimination of the problem(s), the Regional Director will pursue corrective action through an administrative action. The letter should cite the serious and/or persistent problems and the unsafe or unsound practices which exist and must be corrected. The examiner will provide the regional office with recommended wording for the Preliminary Warning Letter. The examiner can tailor the contents of the warning letter to meet the needs of the individual credit union. Once the preliminary Warning Letter has been issued, the credit union will receive a letter after subsequent examinations or supervision contacts, in instances where the administrative action has not been instituted or withdrawn. The letter will notify the credit union of the status of the problem areas as well as whether an administrative action is still being considered or an extension of time is being given within which the problems are to be corrected.

(3) Recommendations for an Administrative Action: When the examiner believes that an administrative action is necessary to correct financial and/or operational deficiencies, a memorandum will be used to set forth information incidental to the recommendation. When applicable, the memorandum will be attached to the front of the examination report. The examiner will also comment in the Closed Section that such a recommendation was made. Additional guidance is provided under the Supervision tab 2 of the Guide pertaining to Administrative Actions. If EWS Code 3, 4 or 5 is assigned during the examination and persistent and severe problems prevail, the examiner will recommend for or against a Cease and Desist Order. If recommending against such an action, the reasons should be stated. If recommending for the action, the reasons should also be stated.

## 18.9 Workpapers and References

(1) Workpapers

a. NCUA 2010, Examiner Contact Information
b. NCUA 2020, Supervisory Examination Report (folder)
c. NCUA 2030, Examination Overview
d. NCUA 2035, Record of Action
e. NCUA 2036, Supplementary Facts
f. NCUA 2115, Examiner's Findings
g. NCUA 2141, Closed Section

## 19. Forms Listing for Examinations and Supervision

The following is a current list of core and optional forms. A copy of each form is included in this section in form number order.

### FORMS LIST

| NCUA Form | Title Description | Rev Date | Unit of Issue |
|---|---|---|---|
| 2010 | Examiner Contact Information | 5/84 | Set |
| 2013 | Consumer Compliance Checklist | 4/83 | Set |
| 2020 | Supervisory Exam Report (F/D) | 6/84 | Ea |
| 2030 | Examination Overview | 6/84 | Set |
| 2035 | Record of Action | 4/83 | Set |
| 2036 | Supplementary Facts | 4/83 | Set |
| 2045 | Examination Financial Data | 6/86 | Set |
| 2046 | Key Ratios | 6/86 | Set |
| 2047 | Asset Share Ratio | 6/86 | Ea |
| 2050 | Statement of Financial Condition | 5/84 | Set |
| 2051 | Statement of Income | 4/83 | Set |
| 2055 | Examination Scope | 6/86 | Ea |
| 2056 | Suggestion Form | 6/86 | Set |
| 2060 | Trends and Ratios | 6/86 | Ea |
| 2075 | Spread Analysis Worksheet | 6/86 | Ea |
| 2095 | Trial Balance | 10/82 | Ea |
| 2105 | Subsidiary Ledgers | 8/84 | Ea |
| 2110 | Collection Problem Loans | 6/86 | Set |
| 2115 | Examiner's Findings | 4/83 | Set |
| 2120 | Loan Exceptions | 4/83 | Set |
| 2130 | Management | 6/86 | Set |
| 2141 | Closed Section | 4/83 | Set |
| 2142 | Seven Column Worksheet | 5/76 | Pad |
| 2170 | Examination Information | 10/82 | Ea |
| 2210 | Allowance for Loan Losses | 6/86 | Ea |
| 2220 | Reserves and Undivided Earnings | 10/82 | Ea |
| 2230 | Board Minutes | 12/81 | Ea |
| 2238 | Corp. Central Loan Profile | 6/80 | Ea |
| 2255 | Loan Data Sheet | 6/86 | Ea |
| 2265 | Loan Internal Controls | 6/86 | Set |
| 2270 | Loan Profile | 12/81 | Ea |
| 2280 | Large/Real Estate Loan Profile | 12/81 | Ea |
| 2285 | Insiders' Loans | 6/86 | Ea |
| 2290 | Line of Credit-Credit Cards | 10/82 | Ea |
| 2296 | Commercial Loan Review Checklist | 6/86 | Ea |
| 2299 | Examination Kit | 4/83 | Kit |
| 2300 | Large Loans/Concentrations | 10/82 | Ea |
| 2310 | Collection Program | 10/82 | Set |
| 2362 | Criminal Referral Form | 6/86 | Ea |
| 2375 | Investment Trial Balance | 12/81 | Ea |
| 2380 | Commitments to Purchase/Sell Securities | 12/81 | Ea |
| 2390 | Investment Internal Controls | 6/86 | Set |
| 2391 | Credit Union Service Organization | 6/86 | Ea |
| 2395 | Investment Supplement | 6/86 | Set |
| 2425 | Cash Internal Controls | 6/86 | Set |
| 2430 | Federal Reserve Payment System Risk Program | 6/86 | Ea |
| 2435 | CFT Letter | 6/86 | Set |
| 2460 | Over/Under Payment | 11/85 | Set |
| 2610 | Follow Up Examination | 4/83 | Set |
| 2611 | Follow Up Continuation | 4/83 | Set |
| 2963 | Projections of Balance Sheet and Income/Expense Items | 12/81 | Ea |
| 2999 | Forms List | 6/86 | Ea |

## INSTRUCTIONS FOR COMPLETING NCUA 2010

| | |
|---|---|
| **FUNCTION:** | |
| **EXAMINATION -** | Use this space if the information results from a regular or follow-up examination. You must complete all required information on this form. |
| **SUPERVISION -** | Use this space if the information updates specific data (i.e., to change or delete a problem code). As a minimum you must complete the **CHARTER** number, **CU NAME, EMPLOYEE NUMBER, EMPLOYEE NAME, EFFECTIVE DATE OF THE MOST RECENT CONTACT, DATE COMPLETED, CONTACT TIME** and **CONTACT TYPE.** You should also review the **EST. RESOLUTION DATE** and **DATE OF NEXT CONTACT** to make sure they are current. Once you have done the above you need only enter the information that is to be changed or deleted |
| **CORRECTION -** | Use this space if you are correcting data from a previous contact that was entered in error (i.e., an incorrect problem code or percentage) or you are changing the credit union's address, phone, etc. As a minimum, you must enter a **CHARTER** number, **CU NAME, EMPLOYEE NUMBER, EFFECTIVE DATE OF CONTACT TO BE CORRECTED, DATE COMPLETED,** and **CONTACT TYPE.** |
| **CHARTER INS. CERT.:** | Enter the five-digit charter number (i.e., 23456 or 00234). For State CUs use their NCUSIF Insurance Certificate Number or other NCUA assigned number. |
| **REGION:** | Enter the single digit number for the Region to which the credit union is assigned. |
| **SE/DST:** | Enter the SE Group and the District number to which the credit union is assigned (i.e., G/66 or H/02). |
| **CU NAME:** | Enter up to the first 35 letters and/or numbers of the credit union's name. |
| **ADDRESS:** | **ONLY IF CHANGED,** enter up to the first 35 numbers/letters of the credit union's street address or P.O. Box. |
| **CITY, ST, ZIP:** | **ONLY IF CHANGED,** enter up to the first 23 letters of the city, the two-letter abbreviation of the State and up to nine-digits for the zip code (i.e., Anytown, NY 12345-6789). |
| **AREA/TEL:** | **ONLY IF CHANGED,** enter the credit union's area code and seven-digit telephone number (i.e., (202) 555-1212). |
| **CONTACT PERSON:** | **ONLY IF CHANGED,** enter up to 23 letters of the name of the official responsible for maintaining the credit union's records. |
| **EXAMINERS LAST NAME:** | Enter up to the first 10 letters of the Examiner-in-Charge's last name. |
| **CONTACT TYPE:** | Enter the two digit designation for the type of contact.<br>10– Regular Examination-FCU<br>11– Regular Examination-SCU<br>12– Regular Examination-Corporate CU<br>13– Conversion Examination<br>25– Supervision (f/u Exam. or Other Supervision)-FCU<br>26– Supervision (f/u Exam. or Other Supervision)-SCU<br>27– Supervision (f/u Exam. or Other Supervision)-Corporate CU |
| **EFFECTIVE DATE:** | For **EXAMINATION** enter the effective date of the contact by month, day and year (i.e., 12/31/85 or 06/30/86). For **SUPERVISION** enter the previous month end. For **CORRECTION** enter the effective date of the contact to be corrected. If this is only a change of information such as address, phone, etc. enter the same date as you use for completion of the form. |
| **EMPLOYEE NUMBER:** | Enter the Examiner-in-Charge's four digit employee number (i.e., 1234 or 0124 or 023C). |
| **CONTACT TIME-HRS:** | Enter the four-digits for the total number of hours being charged for this contact (i.e., 0024 or 0235). |
| **DATE COMPLETED:** | Enter the date the contact was completed or the effective date of the change (i.e., 12/06/85 or 06/21/86). |
| **EWS CODE:** | Enter the single-digit EWS Code (1 thru 5). |
| **EST. RES. DATE:** | For credit unions assigned an EWS Code 4 or 5, enter the estimated month and year that the EWS Code will be upgraded to at least a code 3 (i.e., 06/86 or 11/85). |
| **DATE OF NEXT CONTACT:** | Enter the estimated date of the next examiner contact (i.e., 06/20/85 or 10/05/86). |
| **KEY RATIOS:** | From NCUA 2046-Key Ratios, enter a three-digit number for **CAPITAL** and the **PROBABLE ASSET-SHARE RATIO** (i.e., 099 or 102). For the **DELINQUENT LOANS** and the **NET INCOME (LOSS) FROM OPERATIONS TO ASSETS** ratios you should round the figure off to the nearest 1/10 percent (i.e., 02.3). If a ratio is a negative percentage, place a minus (-) sign before the number (i.e., -01.3). |
| **FINANCIAL DATA:** | Enter the total dollar amount, as of the effective date of the contact, of **ASSETS, SHARES, LOANS,** and **DELINQUENT LOANS. NOTE: DO NOT ENTER CENTS.** |
| **PROBLEM AREA:** | Using two digits each for month and year, enter the date the problem area was identified. You may use up to 20 letters, numbers, and spaces to comment on the problem. Problem areas listed as **SPECIAL** can be used to capture data of either regional or national interest. Instructions for use of these fields will be distributed to examiners on an as needed basis. **NOTE:** A problem area must be assigned to all EWS code 2,3,4, and 5 credit unions. **OTHER** may be used with a brief explanation in the **COMMENTS** area. If you are using this form to delete a problem code only, follow the instructions for **SUPERVISION** and enter **DELETE** in the **COMMENTS** area. No **DATE IDENTIFIED** should be listed. |
| **DETAIL OF TIME WORKED:** | List the initials of all examiners involved in the contact, each month/day/year that time is being charged, and the number of hours for each examiner. This information is **NOT** entered into the system and examiners may modify this space to meet the need of each examination team or time. |
| **EXAMINER COMMENTS:** | Up to 200 letters, numbers, and spaces may be used to explain supervision plans or any other aspect of the contact. Understandable abbreviations can be used. **NOTE:** All comments will be entered into the data base. |
| **REGIONAL USE:** | This information is **NOT** entered into the system. |

## EXAMINER CONTACT INFORMATION

FUNCTION: EXAMINATION (    ) SUPERVISION (    ) CORRECTION (    )

CHARTER OR INS. CERT. ☐ CU NAME ☐

REGION ☐ ADDRESS ☐

SE/DST [ / ] CITY, ST, ZIP ☐

AREA/TEL [ (    )    - ] CONTACT PERSON ☐

EXAMINER'S LAST NAME ☐ CONTACT TYPE ☐ EFFECTIVE DATE [ /  / ]

EMPLOYEE NUMBER ☐ CONTACT TIME (HRS) ☐ DATE COMPLETED [ /  / ]

EWS CODE ☐ EST. RESOLUTION DATE [ / ] DATE OF NEXT CONTACT [ /  / ]

KEY RATIOS (%): CAPITAL ☐ EARNINGS [ . ]

DELINQUENT [ . ] PAS ☐

ASSETS $ ☐

LOANS $ ☐

SHARES $ ☐

DELINQ. $ ☐

| PROBLEM AREAS | DATE IDENTIFIED | COMMENTS *(20 character limit)* | PROBLEM AREAS | DATE IDENTIFIED | COMMENTS *(20 character limit)* |
|---|---|---|---|---|---|
| RECORDKEEPING | / | | INVESTMENTS | / | |
| PROFITABILITY | / | | MANAGEMENT | / | |
| AUDIT/VERIFY | / | | OTHER | / | |
| DELINQUENCY | / | | SPECIAL 1 | / | |
| LOAN QUALITY | / | | SPECIAL 2 | / | |
| FULL-FAIR DISCL | / | | SPECIAL 3 | / | |
| LIQ/FUNDS MGMT | / | | SPECIAL 4 | / | |

| DETAIL OF TIME WORKED | | | | | |
|---|---|---|---|---|---|
| **EXAMINER'S** | | | | | |
| HOURS AND INITIALS | | | | | |
| DATE | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | TOTAL HOURS | |

**EXAMINER COMMENTS**
INCLUDING SUPERVISION PLANS
*(200 character limit)*

REGIONAL USE ____________

**DISTRIBUTION**: White - Region; Pink - Supervisory Examiner; Yellow - Examiner

**NCUA 2010 (Rev. 12/85**

## CONSUMER COMPLIANCE CHECKLIST

Charter No. ____________________

Examination Date ________________

| FCU NAME | REGION | ASSETS |
|---|---|---|
| | | |

| INDICATE (✓) IN APPROPRIATE COLUMN | YES | NO | N/A* |
|---|---|---|---|
| **REGULATION Z - TRUTH IN LENDING** | | | |
| **General** | | | |
| 1. Does it appear that the disclosures are based on the terms of the legal obligation? (226.5(c) or 226.17(c)) | | | |
| 2. Does it appear that the right of recission notice is given when required? (226.15 or 226.23) | | | |
| 3. Does it appear that the required disclosures are made when voluntary credit insurance is offered? (226.4(d)(1)) | | | |
| 4. Does it appear that the disclosed interest rates are those actually used by the FCU? (226.7(d)(g) and 226.18(e)) | | | |
| • 5. Are disclosures clear, conspicuous, in writing and in a form the member can keep? (226.5(a)(1) or 226.17(a)(1)) | | | |
| • 6. Are the terms "annual percentage rate" and "finance charge" more conspicuous? (226.5(a)(2) or 226.17(a)(2)) | | | |
| • 7. Are variable rate disclosures made? (226.6(a)(2) or 226.18(f)) | | | |
| • 8. Is property insurance properly excluded from the finance charge? (226.4(d)(2)) | | | |
| **Open-End Credit** | | | |
| 9. Does the FCU offer open-end credit? If not, skip questions 10 through 16. | | | |
| **Initial Disclosure** | | | |
| 10. Are the periodic rates and corresponding APR's disclosed? (226.6(a)(2)) | | | |
| • 11. Are the finance charge disclosures made? (226.6(a)(1) -(4)) | | | |
| • 12. Are all other initial disclosures made? (226.6(b) - (d)) | | | |
| **Periodic Statement** | | | |
| 13. Are the corresponding annual percentage rate(s) and finance charge amount(s) disclosed and is the corresponding APR disclosed consistently with the initial disclosure? (226.7(f) and (g)) | | | |
| 14. Are periodic statements furnished at least every 3 months? (226.5(b)(2)) | | | |
| • 15. Does it appear that the billing rights statement is furnished annually or with each periodic statement? (226.9(a)) | | | |
| • 16. Are all other disclosures made? (226.7(a) - (k), 226.8 and 226.9) | | | |
| **Closed-End Credit** | | | |
| 17. Is the finance charge accurately disclosed? (226.18(d)) | | | |
| 18. Is the annual percentage rate accurately disclosed? (226.18(e)) | | | |
| 19. Are the payment schedules and total of payments accurately disclosed? (226.18(g) and (h)) | | | |
| 20. Does it appear that "credit sale" disclosures are made when the FCU sells and finances credit union owned property (e.g., repossessed autos)? (226.18(j)) | | | |
| • 21. Are the disclosures grouped together and segregated from all other information? (226.17(a)(1)) | | | |
| • 22. Are required terms with explanatory language used? (226.18(b)(d)(e)(h) and (j)) | | | |
| • 23. Is the "amount financed" disclosure itemization made or offered? (226.18(c)) | | | |
| • 24. Are all other disclosures made? (226.18(a) - (r) | | | |

Comments:

______________________________

______________________________

______________________________

* Indicates form review questions which are to be completed using the Washington and regional office "Reviewed Forms Listings." N/A means Not Applicable or Not Reviewed.

| INDICATE (✓) IN APPROPRIATE COLUMN | YES | NO | N/A* |
|---|---|---|---|
| **REGULATION B - EQUAL CREDIT OPPORTUNITY** | | | |
| 1. Do loan policies and practices appear to be free from prohibited discrimination/discouragement? (202.4 and 202.5(a)) | | | |
| 2. Does it appear that income is considered as required? (202.6(b)(5)) | | | |
| 3. Does the credit union appear to comply with signature prohibition (such as spouses') requirements? (202.7(d)) | | | |
| 4. Are adverse action notices provided and do they contain an accurate (as reflected in credit committee minutes) reason(s) for rejection? (202.9(a)(1) and 202.9(b)(2)) | | | |
| 5. Does it appear that "government monitoring purposes" information is requested on real estate loans? (202.13) | | | |
| • 6. Are loan application documents free from requests for prohibited information and from requests for information in a prohibited manner? (202.5(c) and (d)) | | | |
| • 7. Does the adverse action notice contain the required information? (202.9(a)(2)) | | | |

Comments:

______________________________

______________________________

| INDICATE (✓) IN APPROPRIATE COLUMN | YES | NO | N/A* |
|---|---|---|---|
| **REGULATION E - ELECTRONIC FUNDS TRANSFER** | | | |
| Is there any evidence that the credit union has electronic fund transfers? (205.2(g)) If not, skip this section of the Checklist. | | | |
| **Initial Disclosures** | | | |
| 1. Are disclosures provided to appropriate members in a written form that they may retain (205.7(a)) | | | |
| • 2. Are the disclosures readily understandable? (205.7(a)) | | | |
| • 3. Are all disclosures made as required? (205.7(a)(1)-(10)) | | | |
| **ATM Documentation** | | | |
| 4. Is a written receipt made available to the member when a transaction is initiated at an ATM? (205.9(a)) | | | |
| • 5. Are required disclosures made on the ATM receipt? (205.9(a)(1)-(6)) | | | |
| **Periodic Statement** | | | |
| 6. Does it appear that periodic statements are furnished monthly (or quarterly, if applicable)? (205.9(b)) | | | |
| 7. Does it appear that an error resolution notice is furnished annually or with each periodic statement? (205.8(b)) | | | |
| • 8. Are all disclosures made as required? (205.9(b)) | | | |

Comments:

______________________________

______________________________

| INDICATE (✓) IN APPROPRIATE COLUMN | YES | NO | N/A* |
|---|---|---|---|
| **REGULATION X - RESPA** | | | |
| Does the FCU grant residential, real estate loans secured by a first lien on the property?<br>If not, skip this section of the Checklist. | | | |
| 1. Does it appear that the HUD Special Information Booklet is provided to members? (3500.6) | | | |
| 2. Does it appear that a "good faith estimate" form is provided to appropriate members? (3500.7) | | | |
| 3. Does it appear that the Uniform Settlement Statement Form (HUD Form 1) is provided to appropriate members? (3500.8) | | | |
| 4. Does it appear that RESPA and Truth in Lending forms are prepared without charge? (3500.12) | | | |

Comments:

______________________________

______________________________

**A check mark in the shaded space after any question indicates a possible violation.**

(4/83) NCUA 2013

# NATIONAL CREDIT UNION ADMINISTRATION
# SUPERVISORY EXAMINATION REPORT

______________________________
Federal Credit Union

Charter Number ______________________

As of ______________________

Rating (EWS Code) ______________________

A supervisory examination of your credit union was conducted by the National Credit Union Administration in accordance with the standard examination procedures of the Agency. The information herein is based on the books and records of the credit union, on statements made to the examiner by directors, officers and employees and on information obtained from other sources believed to be reliable and correct. It is emphasized that a National Credit Union Administration supervisory examination is not an audit and should not be construed as such. This examination report is confidential and under no circumstances should the information contained herein be disclosed to any person not officially associated with the credit union.

The objectives of the examination were to:

Evaluate the credit union's financial soundness;

Appraise the quality of management;

Develop plans with officials to correct areas of weaknesses; and

Determine the degree of risk to the National Credit Union Share Insurance Fund.

The Supervisory Examination Report is designed to give officials meaningful information on significant items noted during the examination. The report is intended to be a reference source and action document to be used by the officials between examinations. Workpapers in the report are designed in such a way that the officials can adopt the format for their use in an on-going process of reporting, evaluating and controlling the operations of the credit union.

Directors and committee members are responsible for managing the credit union. By accepting the positions of trust of your respective offices, you have indicated that you will act in the best interest of the membership. Giving appropriate consideration to the matters called to your attention during this contact and in this report is an important step toward fulfilling this responsibility.

If the board is not in substantial agreement with the contents and conclusions of this report, a request should be made promptly to the Regional Director for a review of these matters. All correspondence should be addressed to the Regional Director, National Credit Union Administration.

______________________________
Examiner in Charge

______________________________
Date

**(Rev. 6/84) NCUA 2020**

The EWS Code assigned during the examination is generally defined as follows:

A Code 1 credit union has no major areas of concern. It is soundly operated, has no financial problems and is not in violation of the laws and regulations which govern its operations. (Excellent)

A Code 2 credit union is above average; it could be better, but it has no severe problems. The problems it does have are not material and should be readily correctable without supervisory attention beyond the examination. (Good)

A Code 3 credit union has problems that need further attention. An example might be a credit union that is operating at a deficit but has enough surplus in its Undivided Earnings to continue operations for a sustained period (2 years). Other examples might be internal control weaknesses throughout a credit union's operation or serious violations of laws or regulations. In general, a Code 3 credit union has some problems that need attention but is not expected to fail. (Fair)

A Code 4 credit union has very severe financial problems or deliberate violations of laws and regulations. An example might be a credit union that is operating at a deficit without enough surplus to pay a dividend. A Code 4 credit union may have to liquidate if its problems are not resolved, but the problems are resolvable. (Weak)

A Code 5 credit union will probably fail within 12 months if the deficiencies are not corrected. Failure includes liquidation or merger. Code 5 will be assigned only when the credit union is insolvent, or is expected to become insolvent within 12 months, according to the definition of insolvency in Part 700 of the National Credit Union Administration Rules and Regulations (700.1(k)(1)). (Unsatisfactory)

Receipt of this Supervisory Examination Report is acknowledged. The contents of the report were discussed with at least the key officials of the credit union. The complete report must be presented to the board of directors at the next regular board meeting. After every official has reviewed the report and initialed in the space below, the report will be maintained on file in the credit union's office. When a Record of Action is enclosed, it is understood that action will be taken to correct any areas of concern, or any substantial disagreement with the contents of the report will be reported promptly to the Regional Director.

Date ______________ Name ______________________________ Title

| Board of Directors |
|---|
| |
| |
| |
| |
| |
| |
| |
| |
| |
| |
| |
| |
| |

| Credit Committee |
|---|
| |
| |
| |
| |
| |
| |
| |

| Supervisory Committee |
|---|
| |
| |
| |
| |
| |

# EXAMINATION OVERVIEW

Charter No. ______________

Examination Date ____________________

---

The following comments summarize the examiner's review, analysis and findings in major areas of the credit union's operation, financial condition and management. Based upon a review of key financial trends and ratios, the scope of the examination may have been limited in areas where no existing or potential problem is apparent. Accordingly, comments in these areas may be more general in nature to reflect the limited review.

---

# RECORD OF ACTION

Chapter No. ____________________

Examination Date ________________________

| Area of Concern and Plans for Corrective Action | Responsible Person(s) and Time Frames |
|---|---|
| | |

(Rev. 4/83) NCUA 2035

## SUPPLEMENTARY FACTS

Charter No. ________________

Examination Date ________________

---

## INSTRUCTIONS

Examination Financial Data is an internal NCUA workpaper. It may be shared with officials, but was not designed for this purpose. A copy of the completed NCUA 2045 will be included with the regional office copy of the examination report. The original NCUA 2045 will be kept with the field copy of the examination workpapers.

Enter data for the current examination date in the right hand column and data from the previous examination date or other date deemed more relevant by the examiner in the left hand column. When review of the collected data discloses adverse or unusual conditions or trends an extended review can be made by completing the middle columns for interim periods. The examiner may use whatever interim periods are most meaningful. The periods used will be clearly labeled. It is not necessary to collect all the data for an interim period if such information will not be useful.

Usually the data collected for the current examination will be identical to the information contained on the financial reports submitted with the supervisory Examination Report. Examiners will use projected or pro-forma data when the examiner determines these amounts more accurately reflect the credit union's condition. Projected or pro-forma amounts will be clearly footnoted. Workpapers detailing the computation of projected or pro-forma amounts will be included with examination papers.

When completing the income and expense items (lines 25 through 31) for the current examination period, previous period and interim periods, the examiner should use whatever data is readily available and which the examiner considers most meaningful. Examples include last full year, year to date or accounting period to date, and quarter or semiannual period. The income period used will be clearly labeled in the period portion of the form.

### A Brief Explanation of Each Line Item Follows:

3. TOTAL INVESTMENTS—Include NCUSIF deposit.

6. NON-EARNING ASSETS—The sum of all assets which do not generate revenue. Usually all assets except loans and investments. Do not include cash in this total. The FPRs do not include cash in calculating the ratios of non-earning assets to average assets.

8. AVERAGE ASSETS—Net Assets from the previous period plus the current period divided by 2. If there have been erratic fluctuations of assets during the period, the assets for each month in the period should be totaled and divided by the number of months in the period.

9. The average assets will be calculated to correspond with the income period on lines 25 through 31. If the income period is for the first four months of the year, then the average assets will be based on this same period.

10, 11, 12. SHARES—Major share account categories at the examiner's discretion.

15. REVOCABLE RESERVES—Sum of all other revocable reserve accounts including Undivided Earnings. Items 34 and 35 from FCU 109A.

16. TOTAL RETAINED EARNINGS—Sum of lines 14 and 15.

17. DELINQUENT LOANS—EXCESS OF 2 MONTHS—The total of all loans delinquent more than 2 months.

## EXAMINATION FINANCIAL DATA

Charter No. ____________________

Examination Date ____________________

| | PERIODS | | | |
|---|---|---|---|---|
| | | | | |
| 1. Total Loans (Gross) | | | | |
| 2. Investments Greater than 1 Year | | | | |
| 3. Total Investments | | | | |
| 4. Investment Market Value | | | | |
| 5. Cash | | | | |
| 6. Non-Earning Assets | | | | |
| 7. Total Assets | | | | |
| 8. Average Assets | | | | |
| 9. Liabilities | | | | |
| 10. ____________________ | | | | |
| 11. ____________________ | | | | |
| 12. ____________________ | | | | |
| 13. Total Shares | | | | |
| 14. Statutory Reserves (ALL & Reg Res) | | | | |
| 15. Revocable Reserves (UE & Other Res) | | | | |
| 16. Total retained earnings | | | | |
| 17. Delinquent Loans—Excess of 2 Mths | | | | |
| 18. Collection Problem Loans | | | | |
| 19. Allowance for Loan Losses | | | | |
| 20. Provision for Loan Loss Expense | | | | |
| 21. Charged Off Loans (Net) | | | | |
| 22. Other Potential Losses | | | | |
| 23. ____________________ | | | | |
| 24. ____________________ | | | | |
| IDENTIFY PERIOD USED (YTD, QTR, MONTH) | | | | |
| 25. Gross Income | | | | |
| 26. Cost of Funds | | | | |
| 27. Operating Expenses | | | | |
| 28. Non-Operating Gain or (Loss) | | | | |
| 29. Net Income (Loss) After Dividends | | | | |
| 30. Net Reserve Transfer | | | | |
| 31. Net Income (Loss) from Operations | | | | |

COMMENTS/FOOTNOTES:

### TRIGGERS

A Yes answer to any of the Triggers below indicates a need to expand the analysis in that area. In determining the extent of the analysis of the "Yes" answers, the date above, the ratios on NCUA 2046 Key Ratios, and other quantitative data known to the examiner needs to be considered.

| | Yes | No |
|---|---|---|
| 1. Material Increase/Decrease in Total Assets | | |
| 2. Material Change in Loan Structure | | |
| 3. Material Change in Investment Structure or Maturity | | |
| 4. Material Change in Share Structure | | |
| 5. Material Decline in Total Retained Earnings | | |
| 6. Material Increase in Total Delinquent Loans and/or Delinquent Loan Ratio | | |
| 7. Material Increase in Ratio of Classified Loans to Total Retained Earnings | | |
| 8. Negative or Decreasing Ratio of Net Income from Operation to Assets | | |
| 9. Decreasing Trend in Probable Asset Share Ratio | | |
| 10. Erratic Trends or Ratios | | |

INSTRUCTIONS ON REVERSE

(Rev. 6/86) NCUA 2045

## INSTRUCTIONS

The ratios will normally be completed for the same periods for which data was collected on NCUA 2045, Examination Financial Data. The period columns will be clearly dated and arranged in chronological order from the oldest to the most recent. Consideration should be given to using one column for a full calendar year of income/expense data (ratios 9-13) if periods do not provide meaningful analysis.

The most recent FPR peer group average will be listed for those ratios calculated by the FPR. The credit union's peer group average can be obtained from the credit union's most recent FPR.

Ratios 1, 5, 11, 12, 13, 14 and 15 must be annualized to provide a meaningful basis for comparison. Data can be annualized by multiplying by 4 if the data is for a quarterly period, or by multiplying by 2 if the data is semiannual. If the data is for other than a quarter or semiannual period, multiply by 12 and divide by the number of months in the period.

NCUA 2045 collects most of the data necessary to compute the Key Ratios. The market growth and capital ratios for the previous date will be computed by using the share and total retained earnings balances for a period 12 months prior to that date. This data can be obtained from the credit union's financial reports.

The Key Ratios are computed by using the following formulas and line items from NCUA 2045:

MARKET GROWTH: Line 13 current period less line 13 prior period, divided by line 13 prior period. Annualized as necessary.

LOANS TO ASSETS: Line 1 divided by line 7.

LOAN LOSSES RATIO: Line 21 divided by average loans. See Section 8.1-1 for a more detailed description of calculation; ratio should be carried out to three decimal places (e.g. .273).

DELINQUENT LOANS: Line 17 divided by line 1.

RETAINED EARNINGS CHANGE: Line 16 current period less line 16 prior period divided by line 16 prior period. Annualized as necessary.

CAPITAL: The sum of line 13 and line 16 divided by line 13.

NET WORTH: Line 16 divided by line 7.

PERSONNEL EXPENSES: Salaries and benefits divided by line 25 for the period of review.

YIELD ON ASSETS: Line 25 divided by line 8. Annualized as necessary.

COSTS OF FUNDS TO ASSETS: Line 26 divided by line 8. Annualized as necessary.

OPERATING EXPENSES TO ASSETS: Line 27 less line 20 divided by line 8. Annualized as necessary.

NET INCOME (LOSS) AFTER DIVIDENDS TO ASSETS: Line 29 divided by line 8. Annualized as necessary.

NET INCOME (LOSS) FROM OPERATIONS TO ASSETS: Line 31 divided by line 8. Annualized as necessary.

Line items #9 & #10 are provided for examiner optional information.

# KEY RATIOS

Charter No. ____________

Examination Date ____________

The following ratios are key indicators of the credit union's performance. Similar ratios are computed on the credit union's Financial Performance Report (FPR) distributed by NCUA. All ratios are annualized where necessary when the period covered is less than a full year. The most recent FPR peer group average is listed in the right column when available. The peer group average provides some basis for comparison.

| | PERIODS | | | | FPR PEER GROUP |
|---|---|---|---|---|---|
| | | | | | |
| ***1. MARKET GROWTH**<br>Present period shares less prior period shares divided by prior period shares. Share growth is an indicator of the credit union's services and of its ability to compete for member savings. Growth in excess of the dividend rate indicates real growth. | | | | | |
| **2. LOANS TO ASSETS**<br>Total Loans divided by total assets. This ratio measures the percent of assets invested with the membership. | | | | | |
| **3. LOAN LOSSES**<br>Net loans charged off divided by average loans. Loan charge-offs are an important indicator of effective or ineffective lending and loan collection practices. | | | | | |
| **4. DELINQUENT LOANS**<br>Delinquent Loans divided by total Loans. This ratio measures delinquency control. A high ratio is cause for concern and indicates a potential for future losses on loans. | | | | | |
| ***5. RETAINED EARNINGS CHANGE**<br>Present period Retained Earnings (total Reserves, ALL and Undivided Earnings) less prior period Retained Earnings divided by prior Retained Earnings. A positive ratio indicates growing equity which is desirable and enhances a credit union's ability to absorb losses. | | | | | |
| **6. CAPITAL**<br>Total Retained Earnings and total Shares divided by total Shares. This ratio is the relative worth of a dollar of Shares without adjustment for losses. A low value indicates limited protection for member savings. | | | | | |
| **7. NET WORTH**<br>Total Retained Earnings divided by total assets. This ratio measures the accumulated equity generated and its relationship to assets. An increasing ratio is one indicator of financial strength. | | | | | |
| **8. PERSONNEL EXPENSES**<br>Total salaries and benefits divided by gross income. This ratio measures the percentage of gross income allocated to personnel expenses, which is the largest category and is critical to overall operating expense control. A low or decreasing ratio is one indicator of operational efficiency and productivity. | | | | | |
| 9. ____________ | | | | | |
| 10. ____________ | | | | | |

The following ratios are components of profitability which must be related to one another. An individual ratio is not as important as the credit union's ability to maintain positive earnings. The Net Income ratios should be positive. However, the magnitude of the ratios must ultimately be measured by management's goals and objectives for services and return to members.

| | | | | | |
|---|---|---|---|---|---|
| ***11. YIELD ON ASSETS**<br>Gross income for period divided by average assets (the average of the previous and current period's assets). | | | | | |
| ***12. COST OF FUNDS TO ASSETS**<br>Cost of funds divided by average assets. | | | | | |
| ***13. OPERATING EXPENSES TO ASSETS**<br>Operating Expenses less the Provision for Loan Losses and cost of funds (Cost of Borrowed Money and Dividends) divided by average assets. | | | | | |
| ***14. NET INCOME (LOSS) AFTER DIVIDENDS TO ASSETS**<br>Earnings after Dividends but before statutory Reserve transfers divided by average assets. | | | | | |
| ***15. NET INCOME (LOSS) FROM OPERATIONS TO ASSETS**<br>Earnings after net Reserve transfers divided by average assets. | | | | | |

* Annualized.

SEE INSTRUCTIONS ON REVERSE

# INSTRUCTIONS

## PROBABLE ASSET SHARE RATIO

The Probable Asset Share Ratio (PAS) reflects a credit union's financial condition based on an on-going concern concept. Differences between market value and book value are not likely to materialize.

### ADDITIONS

1. Loans are valued at book value less classified loans.
2. Investments will be valued at book value less any known losses. However, if there is a likelihood that a long term investment will need to be liquidated prior to maturity, it will be valued at the current market value.
3. All other assets will be valued by the examiner at the most realistic value to the credit union based on an on-going concern concept. This usually will not exceed book value. An NCUSIF Guaranty Account should be valued at book value.

### DEDUCTIONS

1. All liabilities are valued at book.
2. Contingent and/or unrecorded liabilities are valued at the most realistic known value. This item will include any unrecorded dividends that have not been accrued for the accounting period.
3. Subsidiary Ledger Differences are deducted if the credit union is likely to suffer a loss due to the problem.
4. Other Losses—This item includes all other known losses. Deficits in Undivided Earnings and net losses should not be deducted because their proper recording has already reduced assets.

Total (A) is the combined value of assets. Total (B) is the combined value of deductions and is subtracted from (A) to obtain the net value of assets to the on-going concern.

The Probable Asset Share Ratio is computed by dividing the net value of assets by the total of all shares. The resulting ratio reflects the relative worth of $1.00 of shares in the credit union using an on-going concern concept. The ratio should equal or exceed 100 for a solvent credit union and have a stable or increasing trend over time.

# ASSET SHARE RATIO

Charter No. ____________________

Examination No. ____________________

| | Recorded Book Value | On Going Concern Value |
|---|---|---|
| Additions | | |
| Loans | $ ____________ | $ ____________ |
| Investments | ____________ | ____________ |
| Cash and Non-Earning Assets | ____________ | ____________ |
| ____________ | ____________ | ____________ |
| ____________ | ____________ | ____________ |
| Total (A) | | $ ____________ |
| Deductions | | |
| All Recorded Liabilities | $ ____________ | $ ____________ |
| Contingent and/or Unrecorded Liabilities | ____________ | ____________ |
| Subsidiary Ledger Differences (Losses) | ____________ | ____________ |
| Other Losses ____________ | ____________ | ____________ |
| ____________ | ____________ | ____________ |
| ____________ | ____________ | ____________ |
| Total (B) | | $ ____________ |
| Net value of Assets (A—B) | | $ ____________ |
| Net Value of Assets<br>Total Shares | | ____________ %<br>(PAS) |

(REV. 6/86) NCUA 2047

# STATEMENT OF FINANCIAL CONDITION

**Charter No.** ____________________

**As of** ______________________________________________

| ASSETS | AMOUNT |
|---|---|
| Loans to Members | $ |
| Other Loans | |
| Less: Allowance for Loan Losses | |
| Net Loans | |
| Other Receivables | |
| Cash | |
| Investments (1) | |
| Prepaid and Deferred Charges | |
| Fixed Assets | |
| Accrued Income | |
| All Other Assets | |
| ______________________________ | |
| ______________________________ | |
| **Total Assets** | $ |
| **LIABILITIES AND EQUITY** | |
| Accounts Payable | $ |
| Notes and Interest Payable | |
| Dividends Payable | |
| Interest Refunds Payable | |
| Taxes Payable | |
| Accrued Expenses | |
| Other Liabilities | |
| Unapplied Data Processing Exceptions | |
| Deferred Charges | |
| ______________________________ | |
| ______________________________ | |
| **Total Liabilities** | $ |
| Share Certificates | $ |
| Share Drafts | |
| Other Shares | |
| Regular Reserves | |
| Other Reserves | |
| Undivided Earnings | |
| Net Income (Loss) | |
| ______________________________ | |
| ______________________________ | |
| **Total Liabilities and Equity** | $ |

Footnotes:

(1) The current market value of the investment portfolio is $ ________________ .

(2)

(3)

(4)

(5)

# STATEMENT OF INCOME

Charter No. ____________

As of ____________________

| OPERATING INCOME | | | For Period From ____19____ thru ____19____ | % | * PRO FORMA ____19____ thru ____19____ | % |
|---|---|---|---|---|---|---|
| Interest on Loans (Gross) | | | | | | |
| Less: Interest Refunded | | | | | | |
| Net | | | | | | |
| Income from Investments | | | | | | |
| Other Operating Income | | | | | | |
| Total Gross Income | | | | | | |
| **OPERATING EXPENSES** | | | | | | |
| Compensation | | | | | | |
| Employee Benefits | | | | | | |
| Travel and Conference Expenses | | | | | | |
| Association Dues | | | | | | |
| Office Occupancy Expenses | | | | | | |
| Office Operations Expenses | | | | | | |
| Educational and Promotional Expenses | | | | | | |
| Loan Servicing Expenses | | | | | | |
| Professional and Outside Services | | | | | | |
| Provision for Loan Losses | | | | | | |
| Members' Insurance | | | | | | |
| Federal Operating Fees | | | | | | |
| Cash Over and Short | | | | | | |
| Interest on Borrowed Money | | | | | | |
| Annual Meeting Expense | | | | | | |
| Miscellaneous Expenses | | | | | | |
| Total Operating Expenses | | | | | | |
| Income (Loss) From Operations | | | | | | |
| Non-Operating Gains (Losses) | | | | | | |
| Gain (Loss) on Investments | | | | | | |
| Gain (Loss) on Disposition of Assets | | | | | | |
| Other Non-Operating Income (Expense) | | | | | | |
| Total Non-Operating Gains (Losses) | | | | | | |
| Net Income (Loss) Before Dividends | | | | | | |
| Dividends | | | | | | |
| Net Income (Loss) After Dividends | | | | | | |
| Less: Required Reserve Transfers | | | | | | |
| Plus: Provision for Loan Loss Expense | | | | | | |
| Net Reserve Transfer (Not Less Than "0") | | | | | | |
| Net Income (Loss) From Operations | | | | | | |

Expenses are shown as a percentage of ______ Total Expenses, ______ Income, ______ Assets

*Pro Forma Statement of Income reflects material income or expense items that have not been recorded on the credit union's records. Estimated items are shown with an "E."

# EXAMINATION SCOPE

Charter No. ____________

Examination Date ____________

**AREA OF REVIEW, TESTING AND ANALYSIS**

## GENERAL LEDGER

VERIFY THAT CURRENT FINANCIAL STATEMENTS ACCURATELY REFLECT THE BALANCES IN THE GENERAL LEDGER. ________

DETERMINE THAT SUBSIDIARY LEDGERS AGREE WITH GENERAL LEDGER CONTROL ACCOUNTS. THESE PRIMARILY INCLUDES SHARES, LOANS, INVESTMENTS, AND NOTES PAYABLE BUT MAY ALSO INCLUDE OTHER ACCOUNTS. ________

DETERMINE RECENTNESS AND VERIFY ACCURACY OF THE LATEST BANK RECONCILMENT(S). (INDICATE DATE) ________

TEST ACCURACY OF ACCRUED INCOME:

- INVESTMENTS ________
- LOANS: ________

REVIEW MATERIAL ASSETS ACCOUNTS. THIS MAY INCLUDE INVESTMENTS, FIXED ASSETS, PREPAID AND DEFERRED EXPENSES. ________

REVIEW SHARE DRAFT CLEARING PROCEDURES. ________

CHECK ACCURACY OF DIVIDEND ACCRUALS. ________

REVIEW MATERIAL CONTRACTS FOR CONTINGENT LIABILITIES. ________

REVIEW OTHER MATERIAL LIABILITY ACCOUNTS. THESE MAY INCLUDE NOTES PAYABLE, ACCOUNTS PAYABLE AND ACCRUED LIABILITIES. ________

REVIEW UNAPPLIED DATA PROCESSING EXCEPTION ACCOUNTS FOR PROPER HANDLING. ________

DETERMINE THAT MAJOR INCOME AND EXPENSE ACCOUNTS ARE MATERIALLY ACCURATE. ________

REVIEW EXPENSE APPROVAL PROCEDURES. ________

REVIEW FINANCIAL AND STATISTICAL REPORTS, NCUA 5300, AND FINANCIAL PERFORMANCE REPORT FOR ACCURACY. ________

## SUPERVISORY COMMITTEE

REVIEW SUPERVISORY COMMITTEE ACTIVITIES ________

DATE OF LAST AUDIT ________

DATE OF LAST VERIFICATION ________

**AREA OF REVIEW, TESTING AND ANALYSIS**

## RESERVES

REVIEW PROPRIETY OF ENTRIES IN UNDIVIDED EARNINGS AND RESERVE ACCOUNTS, INCLUDING THE ALLOWANCE FOR LOAN LOSSES. ________

## PROFITABILITY

REVIEW PROFITABILITY. ________

REVIEW BUDGETS AND PROJECTIONS. ________

## FUNDS MANAGEMENT

REVIEW FUNDS MANAGEMENT POLICIES AND PROCEDURES. ________

## MANAGEMENT

REVIEW BOARD AND EXECUTIVE COMMITTEE POLICIES AND PROCEDURES ________

## LOAN ANALYSIS

REVIEW LOAN POLICIES AND PROCEDURES. ________

CALCULATE LOSS RATIO. ________

TEST ACCURACY OF DELINQUENT LOAN LIST. ________

REVIEW COLLECTION PROGRAM INCLUDING CHARGE-OFF PROCEDURES AND FOLLOW-UP PRACTICES. ________

DETERMINE ADEQUACY OF ALLOWANCE FOR LOAN LOSSES. ________

REVIEW THE FOLLOWING TYPES OF LOANS:

| | # REVIEWED | |
|---|---|---|
| INSIDERS' | | |
| CONSUMER | | |
| LINE-OF-CREDIT | | |
| REAL ESTATE | | |
| VARIABLE RATE | | |
| CREDIT CARD | | |
| CONCENTRATIONS | | |
| OTHER | | |
| COMM./AGRI. DELINQUENT | | |

DETERMINE ADEQUACY OF LOAN DOCUMENTATION ________

NOTE: Indicate NCUA Form number or workpaper number used to support analysis when appropriate.

## EXAMINATION SCOPE

### AREA OF REVIEW, TESTING AND ANALYSIS

**INVESTMENT ANALYSIS**

REVIEW INVESTMENT POLICIES, PRACTICES AND CONTROLS.

**SHARE STRUCTURE**

REVIEW SHARE STRUCTURE AND DIVIDEND POLICIES.

REVIEW SHARE OVERDRAFTS.

**CASH ANALYSIS**

REVIEW CASH POLICIES, PROCEDURES AND CONTROLS.

**ELECTRONIC DATA PROCESSING**

REVIEW EDP SYSTEM AND INFORMATION.

**TYPE OF SYSTEM:**

**SUPPLIER (IF ANY):**

NAME

**REGULATION COMPLIANCE**

REVIEW COMPLIANCE WITH THE FOLLOWING REGULATIONS:

- RECORDS PRESERVATION
- SECURITY DEVICES
- SURETY BOND COVERAGE
- NCUA FEES
- MEMBERSHIP ELIGIBILITY
- CONSUMER
- CFT
- OTHERS AS APPLICABLE

**CONCLUSIONS—TOTAL ANALYSIS PROCESS**

REVIEW CORRECTIVE ACTIONS TAKEN IN REGARD TO PREVIOUS EXAMINATION AND MOST RECENT AUDIT.

IF SPECIAL ASSISTANCE IS OUTSTANDING, DETERMINE COMPLIANCE WITH LETTER OF UNDERSTANDING.

### AREA OF REVIEW, TESTING AND ANALYSIS

OTHER

NOTE: Indicate NCUA Form Number or workpaper number used t support analysis when appropriate.

# SUGGESTION FORM
# EXAMINER'S GUIDE

*INSTRUCTIONS:* Examiner's are encouraged to submit suggestions for improvements/changes to the Examiner's Guide and the workpapers completed during the examination and supervision of credit unions. Please attach a copy of the form with modifications shown or any newly designed form as appropriate. Forward one copy of this form to your Supervisory Examiner and one to your regional office. Regional offices will forward the suggestion forms to the designated Examiner's Guide Committee Chairperson.

Changes to Examiner's Guide section ______________________________

Changes to forms. Enter title and NCUA form no. ______________________________

Description of recommended changes:

NCUA 2056

## INSTRUCTIONS

1. Figures can be shown in thousands, i.e. $2,562,428.61 becomes 2,562, and percentages in tenths, i.e. 11.076% becomes 11.1%.

2. Record the appropriate information in the Initial Analysis columns (A through G) for the effective date of the examination and the preceding 11 months (1 year in total). Alternatively, record data in quarterly summaries if the data is more readily available in quarterly format.

A. Total assets.
B. Total income, including non-operating income and estimations of material unrecorded items.
C. Total operating expenses, including loan loss expense, interest on borrowed money, non-operating expenses and estimations of material unrecorded items and excluding dividends and reserve transfers.
D. Total loan loss expenses.
E. Total required reserve transfers.
F. Total interest on borrowed money.
G. Total dividends on shares/deposits.

3. Summarize columns A through G for 3 months (the effective date and preceding 2 months) and for 12 months. Calculate the 3 and 12 months average assets.

4. Use the data from columns A and B to determine the Yield on Assets for the 12 month and 3 month periods. Divide income by average assets for the period. Note that all 3 month ratios will have to be annualized by multiplying them by 4 in order to compare them with the 12 month ratios. If the 3 month Yield on Assets is less than the 12 month Yield on Assets, determine the cause. Ratios a, b, and c will assist in this extended analysis.

5. Use the data from columns A, C, D, and F to determine the Operating Expenses to Assets for the 12 and 3 month periods. Divide expenses by average assets for the period. If the 3 month Operating Expenses to Assets is greater than the 12 month Operating Expenses to Assets, determine the cause.

6. Use the data from columns, A, F, and G to determine the Cost of Funds to Assets for the 12 and 3 month periods. Divide interest on borrowed money and dividends by average assets for the period. If the 3 month Cost of Funds is greater than the 12 month Cost of Funds, determine the cause. Ratios d and e will assist in this extended analysis. Divide expense items by average shares and notes payable.

7. Use the Yield on Assets, the Operating Expenses to Assets, and the Cost of Funds to Assets (ratios 1, 2, and 3) to determine the Net Income (Loss) After Dividends. The Net Income (Loss) After Dividends is the percentage of assets that the credit union realizes as profit before net reserve transfers. If the Net Income (Loss) After Dividends for 3 months is less than the Net Income (Loss) After Dividends for 12 months, or if ratio is negative, determine the cause.

8. Use the data from columns A, D, and E and the Net Income (Loss) After Dividends (ratio 4) to determine the Net Income (Loss) From Operations. The Net Income (Loss) From Operations is the percentage of assets that the credit union realizes as profit after net reserve transfers. If the Net Income (Loss) From Operations for 3 months is less than the Net Income (Loss) From Operations for 12 months, or if the ratio is negative, determine the cause. A negative Net Income (Loss) From Operations ratio means that the credit union is operating at a loss. The condition must be corrected. For a further discussion, see the Profitability and Total Analysis Process sections of the Examination Chapter of the Guide.

9. Determine the Projected Gain (Loss). Multiply the average assets by the Net Income (Loss) From Operations (ratio 5). The result will be Gain (Loss) for the next 3 or 12 month period if no changes are made.

10. If applicable, compute the Loan Turnover rate by dividing total loans by the loan payments. This is an approximation that will usually give materially accurate loan turnover information. Data entered in the loan payments column will usually be the monthly credit to the General Ledger Loans account even though it will include early payoffs and refinanced loans. More accurate loan payments data can sometimes be obtained from Posted Transaction Registers.

11. Use the Examiner's Optional Analysis section to review trends as appropriate. The columns may be useful for dividends, share certificates, types of loans, etc.

# SPREAD ANALYSIS WORKSHEET

Charter No. ____________

Examination Date ____________

PROJECTED SPREAD FOR PERIOD ____________

| BALANCE SHEET | (A) ACTUAL AS OF | (B) PROJECTED AS OF | ((A) + (B) − 2) AVG. BAL. SHEET | (C) % TO TOTAL ASSETS | (D) ESTM. YIELD/ COST | (C × D) SPREAD FOR PERIOD |
|---|---|---|---|---|---|---|
| **ASSETS** | | | | | | |
| LOANS (NET) | | | | % | | |
| INVESTMENTS | | | | % | | |
| OTHER | | | | % | -0- | |
| TOTAL | | | | 100% | | |
| | | | **PLUS:** OTHER INCOME TO AVG. ASSETS | | | |
| | | | YIELD ON ASSETS | | | SUB |
| **LIABILITIES AND CAPITAL** | | | | | | |
| SHARES/N.P. | | | | % | | ( ) |
| OTHER | | | | % | -0- | |
| TOTAL | | | | 100% | | |
| | | | **GROSS SPREAD** | | | SUB |
| | | | **LESS:** | | | |
| | | | a. OPER. EXPENSES TO AVG. ASSETS | | | ( ) |
| | | | b. NET RESERVE TRANS. TO AVG. ASSETS | | | ( ) |
| | | | **NET SPREAD + or ( − )** | | | (*) |
| | | | (*) CONVERSION TO DOLLARS: (NET SPREAD × AVG. ASSETS) | | | $ |

ENTER ASSUMPTIONS ON REVERSE

(Rev. 6/86) NCUA 2075

# SPREAD ANALYSIS WORKSHEET

## ASSUMPTIONS

### A. ESTIMATED BALANCE SHEET

1. Share growth for Year .......................................... ____________ %
2. Asset growth for Year .......................................... ____________ %
3. Loan growth for Year .......................................... ____________ %
4. Investment growth for Year .................................... ____________ %

   *OR*

   a. Investment to Asset Ratio at Year End ...................... ____________ %

   *OR*

   b. Loans and Investments to Asset
   Ratio (Solve for Investment Ratio) ............................ ____________ %

### B. ESTIMATED AVERAGE YIELDS, COSTS OR RATIOS

1. Yield on Loans ................................................ ____________ %
2. Yield on Investments .......................................... ____________ %
3. Cost of Funds ................................................. ____________ %
4. Other Income as a percentage of Assets ........................ ____________ %
5. Operating Expenses (Less PLL) to Assets ....................... ____________ %
6. Statutory Reserve Transfer to Gross Inc. ...................... ____________ %

Charter ____________________

Examination Date ____________________

# TRIAL BALANCE

| ACCOUNT NO. | ACCOUNT DESCRIPTION | PER BOOKS |  | ADJUSTMENTS |  | INCOME AND EXPENSES |  | BALANCE SHEET |  | ACCOUNT NO. |
|---|---|---|---|---|---|---|---|---|---|---|
|  |  | DEBIT | CREDIT | DEBIT | CREDIT | EXPENSES | INCOME | ASSETS | LIABILITY & EQUITY |  |
| 700 | Loans to Members *(Number ..........................)* |  |  |  |  |  |  |  |  | 700 |
|  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |
| 719 | Less: Allowance for Loan Losses |  |  |  |  |  |  |  | ▨ | 719 |
|  | Net |  |  |  |  |  |  |  |  |  |
| 720 | Other Receivables |  |  |  |  |  |  |  |  | 720 |
| 730 | Cash |  |  |  |  |  |  |  |  | 730 |
|  |  |  |  |  |  |  |  |  |  |  |
| 740 | Investments |  |  |  |  |  |  |  |  | 740 |
|  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |
| 750 | Accrued Income |  |  |  |  |  |  |  |  | 750 |
| 760 | Prepaid and Deferred Expenses |  |  |  |  |  |  |  |  | 760 |
| 770 | Fixed Assets |  |  |  |  |  |  |  |  | 770 |
|  |  |  |  |  |  |  |  |  |  |  |
| 790 | Other Assets |  |  |  |  |  |  |  |  | 790 |
| 800 | Accounts Payable |  |  |  |  |  |  |  |  | 800 |
| 810 | Notes and Interest Payable |  |  |  |  |  |  |  |  | 810 |
| 820 | Dividends Payable |  |  |  |  |  |  |  |  | 820 |
| 830 | Interest Refunds Payable |  |  |  |  |  |  |  |  | 830 |
| 840 | Taxes Payable |  |  |  |  |  |  |  |  | 840 |
| 850 | Accrued Expenses |  |  |  |  |  |  |  |  | 850 |
| 860 | Other Liabilities |  |  |  |  |  |  |  |  | 860 |
| 870 | Unapplied Data Processing Exceptions |  |  |  |  |  |  |  |  | 870 |
| 880 | Deferred Income |  |  |  |  |  |  |  |  | 880 |
|  |  |  |  |  |  |  |  |  |  | Total Liabilities |
| 900 | Shares *(Number ..........................)* |  |  |  |  |  |  |  |  | 900 |
|  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |
| 920 | Shares of Nonmembers *(Number ..........................)* |  |  |  |  |  |  |  |  | 920 |
| 930 | Reserves |  |  |  |  |  |  |  |  | 930 |
|  |  |  |  |  |  |  |  |  |  |  |
| 940 | Undivided Earnings |  |  |  |  |  |  |  |  | 940 |
| 950 | Donated Equity |  |  |  |  |  |  |  |  | 950 |
| 100 | Operating Income Accounts |  |  |  |  |  |  | ▨ | ▨ | 100 |
| 200-300 | Operating Expense Accounts |  |  |  |  |  |  | ▨ | ▨ | 200-300 |
| 400 | Non-Operating Income and Expense Accounts |  |  |  |  |  |  | ▨ | ▨ | 400 |
| 960 | Net Income (Loss) |  |  |  |  |  |  |  |  | 960 |
|  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |
|  | Totals |  |  |  |  |  |  |  |  |  |

## ADJUSTMENTS

| ADJ. No. | EXPLANATION | DEBIT | CREDIT |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

### INSTRUCTIONS

1. Use this form when material adjustments are made as of the effective date of the examination. Examiner adjustments to the income, expense, asset, liability or equity accounts will be explained on this workpaper and entered on the credit union's records by credit union personnel so that NCUA 2051, Statement of Income, and NCUA 2050, Statement of Financial Condition, will agree with the adjusted credit union records.

# INSTRUCTIONS

1. Record material out-of-balance conditions between General Ledger control accounts and subsidiary ledgers.

2. Enter data for the examination date and the prior six months, or until the ledgers were last in balance, whichever is less.

3. Relatively small differences in Individual Share and Loan Ledgers and cash accounts may be material due to the serious internal control problems such differences usually indicate.

☆ U. S. GOVERNMENT PRINTING OFFICE 1982 261-826/40

# SUBSIDIARY LEDGERS

Charter No. __________

Examination Date ______________

Account No. __________

Name ______________________________

| Date | Subsidiary Ledger Balance | Control Account Balance | Difference* |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | ( ) |

Account No. __________

Name ______________________________

| Subsidiary Ledger Balance | Control Account Balance | Difference* |
|---|---|---|
| | | |
| | | |
| | | |
| | | |
| | | |
| | | ( ) |

Account No. __________

Name ______________________________

| Date | Subsidiary Ledger Balance | Control Account Balance | Difference* |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | ( ) |

Account No. __________

Name ______________________________

| Subsidiary Ledger Balance | Control Account Balance | Difference* |
|---|---|---|
| | | |
| | | |
| | | |
| | | |
| | | |
| | | ( ) |

Comments should be made to identify the length of time the accounts have been out of balance, and, if determinable, the reasons for the out-of-balance condition.

* Indicate whether a difference would result in a gain (+) or a loss (-) if adjusted as of the examination date.

________________________________________

________________________________________

________________________________________

________________________________________

________________________________________

________________________________________

________________________________________

See Instructions on Reverse

# COLLECTION PROBLEM LOANS

Charter No. ______________

Examination Date ______________

## SUMMARY OF DELINQUENT LOANS

| Delinquency Category | Number | Amount |
|---|---|---|
| 2-6 Months | | |
| 6-12 Months | | |
| 12 Months and over | | |
| Total Delinquent Loans | | |

## SELECTED RATIOS AND STATISTICS

Allowance for Loan Losses $______________

Collection Problem Loans $______________

Surplus (Deficit) $______________

Delinquent loans to total loans ________%

Loss Ratio ________%

Delinquent loans to retained earnings ________%

Collection Problem Loans to A.L.L. ________%

Collection Problem Loans to retained earnings ________%

### SIMPLIFIED CLASSIFICATION

The simplified classification procedure is used when it would not impede the credit union's dividend paying ability AND when it would not result in a material over or under statement of the Allowance for Loan Losses.

The simplified classification procedure calls for the Allowance for Loan Losses to equal 50% of the loans between 6 and 12 months delinquent and 75% of the loans over 12 months delinquent.

$______________ × 50% = $______________
6-12 MONTHS

$______________ × 75% = $______________
12 + MONTHS

TOTAL collection problem loans = $______________

INDIVIDUAL CLASSIFICATION: The individual classification procedure rates each delinquent loans as to its collectability.

| REFERENCE | Date Last Prin. Pmt. | Months or Range Delinquent | Estimated Uncollectable | | | COMMENTS |
|---|---|---|---|---|---|---|
| | | | Loan Balance | Amount | | |
| | | | | Doubtful | Loss | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | SUBTOTAL | | | | |
| | | TOTAL COLLECTION PROBLEM LOANS | | | | |

Balances listed as doubtful of full collection have been reduced on the basis of estimated collectability. Loans listed as losses are assets of little or no value and should be charged-off to the Allowance for Loans Losses.

On ______________ the board of directors authorized ______________ loans totalling $______________ to be charged off the Allowance for Loan Losses account.

On ______________ the board of directors authorized an increase of $______________ to the Allowance for Loan Losses account.

# EXAMINER'S FINDINGS

Charter No. ______________________

Examination Date ______________________

| This schedule includes operating exceptions, violations of law or regulation, and/or unsafe and unsound policies, practices or procedures. Other findings have been included on checklists left with officials. | Reference | Discussed With* | Corrected (✓) or Agreed to Correct (✓✓) |
|---|---|---|---|
| | | | |

*Explanation of Symbols in "Discussed With" column:

BD – Board of Directors
SC – Supervisory Committee
JC – Discussed at Joint Conference with Officials
CC – Credit Committee
PR – President
TR – Treasurer
SO – Security Officer
MR – Manager
AT – Assistant Treasurer
LO – Loan Officer
CEO – Chief Executive Officer
CHRP – Chairperson

References:

ACCT – Accounting Manual
ACT – Federal Credit Union Act
BYLAWS – Federal Credit Union Bylaws
RR – National Credit Union Administration Rules and Regulations
SC – Supervisory Committee Manual
CC – Credit Manual
ML – Manual of Laws
IRPS ( ) – Interpretive Ruling and Policy Statement No.
LTR ( ) – NCUA Letter No.

4/83 NCUA 2115

# LOAN EXCEPTIONS

Charter No. ______________

Examination Date ______________________

| Reference | Unpaid Balance | Date of Loan | Comments |
|---|---|---|---|
| | | | |

# MANAGEMENT

Charter No. ____________

Examination Date ____________

"Management" includes all elected and appointed officials and the management team of the credit union. NOTE: A No answer *MAY* indicate a weakness and/or a need for correction.

| | Yes | No | NA | Comments on any items marked NO |
|---|---|---|---|---|
| **FINANCIAL MANAGEMENT** | | | | |
| 1. Have short- and long-range goals and objectives been defined and placed in writing? | | | | |
| 2. Are progress reports on financial and operational goals periodically reviewed? | | | | |
| 3. Are cost/benefit relationships of services periodically analyzed? | | | | |
| 4. Is there an asset/liability management policy in place which addresses liquidity and profitability needs? | | | | |
| 5. Is an income/expense budget prepared? | | | | |
| 6. Are variances between budgeted and actual periodically reviewed and explained in writing? | | | | |
| 7. Is a cash flow budget prepared and reviewed? | | | | |
| 8. Has the Undivided Earnings Account remained stable or increased over the last two dividend periods? | | | | |
| **PERSONNEL MANAGEMENT** | | | | |
| 1. Are accurate position descriptions in place for all employees. | | | | |
| 2. Are all employees, including top management, provided a written evaluation of their performance at least annually? | | | | |
| 3. Do management contracts provide for the following: | | | | |
| a. Measurable performance standards, | | | | |
| b. Conditions for discontinuance of contracts, | | | | |
| c. Compensation increases which do not create unaffordable contingent liabilities. | | | | |
| **OPERATIONAL MANAGEMENT** | | | | |
| 1. Are all operational procedures well defined and in writing? | | | | |
| 2. Are internal controls in key areas periodically reviewed? | | | | |
| **OTHER** | | | | |
| 1. Are board and committee policies well defined and in writing? | | | | |
| 2. Does the board receive detailed financial information at least monthly? | | | | |
| 3. Are material risks adequately insured? | | | | |
| 4. Are audit and examination reports reviewed and formally acted upon for needed corrective action? | | | | |
| 5. Does management strive to achieve the basic purposes for which the credit union was formed? | | | | |

Management should plan, direct and control the operation of the credit union. Larger and/or more complex credit unions need more complex management. A successful management team will ensure that the credit union is operated in a safe and sound manner and in compliance with applicable laws and regulations.

# INSTRUCTIONS

Prepare in a clear, complete and concise style to supplement information in the report; **do not repeat material stated elsewhere.** Information which would help explain a situation to the regional office and/or the next examiner should be included. Do not make comments based on gossip, hearsay or personal prejudice.

The upper portion of the form will always be completed. In instances where there is no need for additional information, the examiner should submit the form with the word "NONE".

Recommendations: Comment on recommendations for follow-up, submittal of periodic reports, transmittal letters and/or administrative actions.

Codes 4 & 5: Comment on timeframes when credit unions coded EWS 4 or 5 will have these codes removed (Merger, upgrading liquidation, etc.).

Include the dates when condition codes were assigned and when the codes will be resolved.

Comment on deviations in examination procedures from those suggested by the Examiner's Guide.

Reference any supporting memorandums prepared during the examination.

When applicable, comment on:

1. Examination date other than month end.
2. Effectiveness of collections on NCUA guaranteed loans.
3. Any deviation from on-site distribution of the final examination report.
4. Explanation of Code "V" - Other.
5. **Material** bond claims opened, opened and closed or closed during the examination.

## CLOSED SECTION

Charter No. ____________

mination Date ____________

Date of Joint Conference or Exit Interview: ____________

Present: ____________ directors ____________ credit com. members ____________ sup. com. members

See Instructions on Reverse

NCUA 2142 (5/76)

CHARTER NO. __________

SCHEDULE __________

Charter No. ____________

# EXAMINATION INFORMATION

| | | | | | | |
|---|---|---|---|---|---|---|
| Examined as of: | | | | | | |
| Examined by: | | | | | | |

Credit union serves: ____________________________________________

Location of, and directions to credit union office: ____________________________________________

____________________________________________

____________________________________________

Location of records (if not on-site): ____________________________________________

Supervisory Committee contact information: ____________________________________________

____________________________________________

Is advance notice needed? ______ Yes ______ No   Comment if "Yes": ____________________________________________

____________________________________________

____________________________________________

Recordkeeping: __________ Hand Posted; __________ Bookkeeping Machine; __________ ADP ____________

Hours of business: From ____________ To ____________ ; Number of employees ____________

Space for __________ examiners; Number of examiners needed __________   Advance team ______ Yes ______ No

Exceptions to routine examination scheduling: ____________________________________________

____________________________________________

____________________________________________

____________________________________________

Lodging and restaurants: ____________________________________________

____________________________________________

____________________________________________

____________________________________________

Miscellaneous Comments: ____________________________________________

____________________________________________

____________________________________________

____________________________________________

____________________________________________

## BRANCH OFFICE OPERATIONS

| List of Branch Offices | Date Visited |
|---|---|
| | |
| | |
| | |
| | |
| | |
| | |
| | |
| | |

## CHARTER/BYLAW HISTORY

| Bylaw Amendments | Date Adopted |
|---|---|
| | |
| | |
| | |
| | |
| | |
| | |
| | |

| Charter Amendments | Date Adopted |
|---|---|
| | |
| | |
| | |
| | |
| | |
| | |

★ U. S. GOVERNMENT PRINTING OFFICE : 1982 261-826/41

# ALLOWANCE FOR LOAN LOSSES

Charter No. ____________

Examination Date ____________

| | | | | | | |
|---|---|---|---|---|---|---|
| Balance<br>Prior Exam ____________<br>(Date) | DR | CR | OTHER RESERVES | | | |
| | | | | Acct. ______ | Acct. ______ | Acct. ______ |
| Provision Adjust. during exam. per. | | | | | | |
| | | | Balances Prior Exam | | | |
| | | | Additions | | | |
| Loans Charged-off/Recoveries | | | | | | |
| | | | Sub-totals | | | |
| | | | Deductions | | | |
| Other Activity: (Explain) | | | | | | |
| TOTALS | | | Sub-totals | | | |
| BALANCE AS OF ________19___ | | | Balances | | | |

INSTRUCTIONS

1. RECONCILE the Allowance for Loan Losses and other reserve accounts from the date of the prior contact through the current effective date.
    a. Include all reserve accounts in 930 series (except the Regular Reserve) and Donated Equity.
    b. Group non-material items for convenience; i.e., quarterly, annually, examination period, etc.
    c. Identify material items individually.

# INSTRUCTIONS

1. Enter the date of the prior examination, and enter the ending balances of the Regular Reserve and Undivided Earnings accounts from the prior examination. Note that the Regular Reserve cannot have a debit balance as an ending balance. Check the General Ledger to determine that all of the adjustments that went into the prior examination's ending balance have been recorded properly.

2. Enter the first date the credit union closed its books after the prior examination. This will depend, to some extent, on how often the credit union closes its books. For example: if the prior examination was as of 2-28, and the credit union closes its books
   (a) Quarterly; enter 3-31.
   (b) Semi annually, enter 6-30.
   (c) Annually; enter 12-31.

If the credit union closes its books more often than quarterly, i.e. monthly or daily, summarize activity quarterly on a 7 column worksheet and complete this form with the quarterly summaries. Attach the worksheet to this form as a supplement (Monthly closings may be entered if the data fits, i.e. an eight to twelve month examination period.)

3. Enter the gross income reflected in the credit union's Net Income account for the date shown. Check the entries in the Net Income account to the individual income accounts to ensure accuracy and to ensure that any interest refunds were deducted from the Interest on Loans prior to closing.

4. Enter the net income for the period. Gross income is reduced by expenses, including loan loss expenses and dividends to arrive at net income.

5. Enter the net income as it was transferred to Undivided Earnings at the end of the period. A net gain is credited to Undivided Earnings; a net loss is debited. This should be the same figure previously entered in the "Net Income" column.

6. Enter the credit union's reserve transfer rate for the period being considered. The transfer rate may vary from period to period as the credit union's risk assets and irrevocable reserves fluctuate.

| Credit Union | Transfer Rate (% of Gross Income) | Until Reserves are % of Risk Assets |
|---|---|---|
| 4+ year old AND $500,000 or more in total assets | 10<br>5 | 4<br>6 |
| Less than 4 years old OR less than $500,000 assets | 10<br>5 | 7.5<br>10 |

7. Enter the amount of the reserve transfer. The figure entered as a debit to Undivided Earnings should be the same figure credited to Regular Reserves. Check to ensure that the amount transferred is the proper percentage of gross income.

8. Enter the amount of period adjustments to the Allowance for Loan Losses that will be "backed" out of Reserves. Adjustments to the Allowance for Loan Losses should flow through the Provision for Loan Losses expense account, then, at the end of the accounting period, be transferred to Undivided Earnings from the Regular Reserve. The net effect would be the same if increases to the Allowance were made directly from the Reserves, but full and fair disclosure provisions would not be met since the credit union would not have shown all operating expenses, i.e. loan losses, on its financial reports. The debit to Reserves and the credit to Undivided Earnings should be the same figure.

9. Record the new balance in Undivided Earnings.

10. Continue the process of instruction 2 through 9 until the most current closing date is reached and entered.

11. Enter the period, gross income and net income since the most recent closing date. For example, during a 2-28 examination, the period would usually be from 1-1 through 2-28. The net income reported must be the same as shown in the Net Income account on the Trial Balance.

12. Add the gross and net income for all periods of the current year.

☆U.S. GOVERNMENT PRINTING OFFICE: 1985—491-589/46102

Charter No. ____________
Examination Date ____________

# RESERVES AND UNDIVIDED EARNINGS

| | TOTAL GROSS EARNINGS | TOTAL NET EARNINGS | Trf. Rate (%) | REGULAR RESERVE | | UNDIVIDED EARNINGS | | |
|---|---|---|---|---|---|---|---|---|
| | | | | DR. | CR. | DR. | CR. | BALANCE |
| Prior Exam ________ 19___ (DATE) | | | | | | | | |
| Since previous examination | | | | | | | | |
| Period ended ________ 19___ | | | | | | | | |
| Gross inc & loss loan transfer | | | | | | | | |
| Period ended ________ 19___ | | | | | | | | |
| Gross inc & loss loan transfer | | | | | | | | |
| Period ended ________ 19___ | | | | | | | | |
| Gross inc & loss loan transfer | | | | | | | | |
| Period ended ________ 19___ | | | | | | | | |
| Gross inc & loss loan transfer | | | | | | | | |
| Period ended ________ 19___ | | | | | | | | |
| Gross inc & loss loan transfer | | | | | | | | |
| Period ended ________ 19___ | | | | | | | | |
| Gross inc & loss loan transfer | | | | | | | | |
| Period ended ________ 19___ | | | | | | | | |
| Gross inc & loss loan transfer | | | | | | | | |
| Period ended ________ 19___ | | | | | | | | |
| Gross inc & loss loan transfer | | | | | | | | |
| Period ended ________ 19___ | | | | | | | | |
| Gross inc & loss loan transfer | | | | | | | | |
| Period ended ________ 19___ | | | | | | | | |
| Gross inc & loss loan transfer | | | | | | | | |
| Period ended ________ 19___ | | | | | | | | |
| Gross inc & loss loan transfer | | | | | | | | |
| Period ended ________ 19___ | | | | | | | | |
| Gross inc & loss loan transfer | | | | | | | | |
| Period ________ to ________ | | | | | | | | |
| Current year to date | | | | | | | | |
| Other Transfers (Describe): | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| TOTALS | | | | | | | | |
| BALANCES ____________________ 19___ | | | | | | | | |

See Instructions on Reverse

(Rev. 10/82) NCUA 2220

| Date Of Meeting | Notes on Important Business Transacted | Optional | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | * Type Meet. | Min. App. | Mem. App. | Exp. App. | Pres. Sign | Sec. Sign | Quorum |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |

* S–Special E–Executive
A–Annual I–Investment
B–Board

☆ U.S. GOVERNMENT PRINTING OFFICE : 1981 [illegible]

# BOARD MINUTES

Charter No. ____________

Examination Date ______________________

Type Code No. ________

| Date of Meeting | Notes on Important Business Transacted | Optional | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | * Type Meet. | Min. App. | Mem. App. | Exp. App. | Pres. Sign | Sec. Sign | Quorum |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |

* S–Special E–Executive
A–Annual I–Investment
B–Board

REMOVE THIS PIECE BEFORE ASSEMBLING INTO EXAMINATION REPORT

Charter No. ____________________

Examination Date ____________________

## CORPORATE CENTRAL LOAN PROFILE

| REFERENCE | Name of Credit Union | Share Balance | Loan Balance | Original Amount or Latest Advance | Date of Loan or Latest Advance | Date of Approved Line | Amount of Approved Line | Quarterly F & S Data Provided? | | Date of Latest S/C Audit | Loan to Share Ratio | EWS Expense Ratio | Loss Ratio (Since Orig.) | Delinquent Loan Ratio | Reserves to Loans | Notes Pay. to Shares | Share Asset Ratio | Fed. Oblig. to Assets | High Risk? | COMMENTS |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | Yes | No | | | | | | | | | | | |
| 1 | | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | | | | | | | |
| 7 | | | | | | | | | | | | | | | | | | | | |
| 8 | | | | | | | | | | | | | | | | | | | | |
| 9 | | | | | | | | | | | | | | | | | | | | |
| 10 | | | | | | | | | | | | | | | | | | | | |
| 11 | | | | | | | | | | | | | | | | | | | | |
| 12 | | | | | | | | | | | | | | | | | | | | |
| 13 | | | | | | | | | | | | | | | | | | | | |
| 14 | | | | | | | | | | | | | | | | | | | | |
| 15 | | | | | | | | | | | | | | | | | | | | |
| 16 | | | | | | | | | | | | | | | | | | | | |
| 17 | | | | | | | | | | | | | | | | | | | | |
| 18 | | | | | | | | | | | | | | | | | | | | |
| 19 | | | | | | | | | | | | | | | | | | | | |
| 20 | | | | | | | | | | | | | | | | | | | | |
| 21 | | | | | | | | | | | | | | | | | | | | |
| 22 | | | | | | | | | | | | | | | | | | | | |
| 23 | | | | | | | | | | | | | | | | | | | | |
| 24 | | | | | | | | | | | | | | | | | | | | |
| 25 | | | | | | | | | | | | | | | | | | | | |
| 26 | | | | | | | | | | | | | | | | | | | | |
| 27 | | | | | | | | | | | | | | | | | | | | |
| 28 | | | | | | | | | | | | | | | | | | | | |
| 29 | | | | | | | | | | | | | | | | | | | | |
| 30 | | | | | | | | | | | | | | | | | | | | |

# INSTRUCTIONS

1. Reference: Enter identifying number needed to locate file for each loan profiled.
2. Name of Credit Union: Enter borrowing credit union's name or charter number.
3. Share Balance: Enter borrowing credit union's share balance in the corporate central.
4. Loan Balance: Enter the balance of this loan.
5. Original Amount or Latest Advance: Enter the original amount borrowed for closed end loans, or the amount of the most recent advance for lines of credit.
6. Date of Loan or Latest Advance: Enter the date that a closed end loan was granted, or the date of the most recent advance under a line of credit.
7. Date of Approved Line: For lines of credit only; enter the date that approval for this line was granted.
8. Amount of Approved Line: For lines of credit only; enter the date that approval for this line was granted.
9. Quarterly F & S Data Provided?: Enter "Yes" or "No", as appropriate, to indicate whether the borrowing credit union provides the corporate central with quarterly Reports of Operations, Income Statements, and Statistical Reports.
10. Date of Latest S/C Audit: Enter the date of the most recent supervisory committee audit that the borrowing credit union supplied to the corporate central.

**RATIOS ARE FOR BORROWING CREDIT UNIONS AND SHOULD BE COMPLETED FROM THE MOST RECENT F & S DATA PROVIDED TO THE CORPORATE CENTRAL.**

11. Loan to Share Ratio: Enter ratio of all loans to all shares.
12. EWS Expense Ratio: Enter ratio of all EWS expenses to all income.
13. Loss Ratio (Since Orig.): Enter ratio of loans charged off, less recoveries, to loans granted since organization.
14. Delinquent Loan Ratio: Enter ratio of delinquent loans to all loans.
15. Notes Pay to Shares: Enter ratio of all notes and interest payable to all shares.
16. Share Asset Ratio: Enter ratio of all shares to all assets, except that a percentage of delinquent loans will not be considered as assets for this computation, as follows:

| Length of Delinquency | Reduction |
|---|---|
| 2 - 6 months | 10% |
| 6 - 12 months | 25% |
| 12 months or more | 80% |

17. Fed. Oblg. to Assets: Enter the ratio of Federal obligations to assets. Include Federal Agency Securities and U.S. Government Obligations as Federal Obligations.
18. High Risk?: Enter a checkmark in this block only when a loan is judged to be a high risk. The judgement should be made from using any availible information, especially data from preceding columns on this form. Evaluate the financial ratios from a national average standpoint, and, if a recent supervisory committee audit is on file, review it for additional information. Refer to Section 12.5-1 of the Comprehensive Examiner's Guide.
19. Comments: Use as needed.

## INSTRUCTIONS

1. List established board policies for each type of lending on this form.

2. When specific policies have not been established, enter the actual practice. For example, if there are no policies for used car loans, but such loans are granted; usually for 24 months at 80 percent of book value, enter the actual practices on this form.

3. Enter dollar amounts, months or years, etc.; do not enter "yes" or "no".

4. Retain this form in the examination report for 2 examinations after it is filled.

5. Examiner's are encouraged to use section "k" data when selecting loan samples and making determinations of the extent of loan review in a particular area. When statistics are not available showing the number and dollar amount of commercial loans in the portfolio, then this in itself could be an indication of a potential problem in this area if said loans are material. Likewise, if statictics are not available on variable rate loans and variable rate loans are prevalent, then the examiner needs to determine how funds management is monitored.

6. Definition of a loan concentration—Section 8.5-1 of the examiners guide defines a loan concentration to be the *greater* of $50,000 or 10% of statutory reserves. In the event 10% of statutory reserves exceeds $200,000, all loans over $200,000 will be reviewed. There will of course be instances when examiners will use lesser amounts. The examiner should insert the dollar amount that would be considered a concentration on the last line of section "k".

## LOAN DATA SHEET

Charter No. ____________________

*Examined as of*

a. Unsecured Loan Limit
  1. Credit Committee
  2. Loan Officer

b. Secured Loan Limit
  1. Credit Committee
  2. Loan Officer

c. Lines of Credit
  1. Credit Committee
  2. Loan Officer

d. Maturity Limits
  1. New Auto Collateral
  2. Used Auto Collateral
  3. Household Goods
  4. Real Estate
  5. Mobile Homes
  6. Other (describe)

e. Collateral Requirements
  1. New Autos
  2. Used Autos
  3. Household Goods
  4. Comakers
  5. Real Estate
  6. Mobile Homes
  7. Others (describe)

f. Insurance on Collateral
  1. Auto
  2. Household Goods
  3. Real Estate
  4. Mobile Homes

g. Interest Rates

h. Number of loan officers

i. Number of loan officers on credit committee

j. Has the board established specific loan policies in writing? (Yes/No)

| k. Loan Structure | # | $amount | # | $amount | # | $amount | # | $amount |
|---|---|---|---|---|---|---|---|---|
| Real Estate Loans | | | | | | | | |
| Commercial Loans | | | | | | | | |
| Variable rate Loans | | | | | | | | |
| Concentrations | | | | | | | | |
| Insider loans | | | | | | | | |
| What $ amount was determined to be a concentration? | | | | | | | | |

If the credit union has a consolidated list of loan policies this list may be attached in lieu of completion of applicable portions of this form.

SEE INSTRUCTIONS ON REVERSE

(Rev. 6/86) NCUA 2255

## PURPOSE OF FORM

1. A "No" answer in either the Insiders' Loans or Credit Committee-Loan Officers sections will usually indicate a violation of the Act, Rules and Regulations or Bylaws.

2. The purpose of identifying violations is more to affect corrective action than to list past errors.

3. A "No" answer in the "Loan Department-Collection Department Internal Controls" section MAY indicate a violation of sound internal controls. Each credit union has differing needs and capabilities in this area; judgment is necessary to determine when a "No" answer needs further attention. Some credit unions maye have one "No", and the examiner will rate internal controls. "Unsatisfactory". Another credit union may have several "No's", but the examiner may conclude that internal controls are "Satisfactory" for that credit union. The questions are not all inclusive; they are merely a tool to use in evaluating the internal controls.

## DISCUSSION OF INTERNAL CONTROL QUESTIONS

1. Persons who approve or disburse loans should be denied access to cash and records to segregate duties as much as possible so that the work of one proves the work of another.

2. Supervisors should regularly review changes in loan items, prepayments and unusual items to prevent unauthorized changes, or "hidden" delinquency, or preferential treatment (possibly illegal) to friends or family of subordinates. Also, supervisors should know what all of their subordinates are doing.

3. Supervisors should review employee's loans to prevent any possible abuses in this sensitive area.

4. Sequential note numbers ensure that all loans are recorded and can be reviewed for propriety and completeness.

5. Tracing some loans back to the minutes ensure that the loans were approved, and that they were disbursed as approved.

6. Loans to supervisors should not be approved by subordinates who may feel pressured to approve a questionable loan.

7. Persons who approve and disburse loans should not work in collections to segregate duties, and to prevent the granting of a ficticious loan that cannot be collected.

8. Supervisors should be aware of what subordinates are doing, and should ensure that collectors are "working" active loans to prevent possible fraud.

9. Collectors who handle cash could be tempted to keep payments and claim such payments were not made.

10. Pre-numbered cash received vouchers are not as good as complete segregation of duties, but help as in 9 above.

11. Loan protection claims filed on non-existent borrowers are one way that funds have been stolen from credit unions.

12. See 11 above.

# LOAN INTERNAL CONTROLS

Charter No. ________________

Examination Date ________________

| **INSIDERS' LOANS** | Yes | No | N/A |
|---|---|---|---|
| 1. Has the board established a processing procedure to assure that income and debt information is complete and to determine total credit union indebtedness of the official (including comaker loans)? (701.21(d)) | | | |
| 2. Are all loans approved by a loan officer or the credit committee? (Bylaws VII or IX whichever is applicable) | | | |
| 3. Are official's loans which result in total indebtedness in excess of $10,000 approved by the board? (701.21 (d)(4)) | | | |
| 4. Are terms for officials the same as for other members? (701.21(d)) | | | |
| 5. Are all approvals recorded on the loan application? (701.21 (c)(3)) | | | |
| **CREDIT COMMITTEE AND/OR LOAN OFFICERS*** | | | |
| 1. Is approval or rejection recorded on loan applications and in the minutes? (Bylaws IX, 3 credit committee only) | | | |
| 2. Are minutes properly prepared, signed, and controlled? (Bylaws IX, 3 credit committe only) | | | |
| 3. Do loan applications contain adequate information to evaluate the borrower's and/or comaker's financial condition? (Bylaws IX, 6 credit committee only), (701.21 (c)(3)) | | | |
| 4. Are the amount and repayment terms consistent with the purpose, ability to repay and collateral of the borrower? (701.21 (c)(4)) | | | |
| 5. Are credit committee meetings held regularly and not less often than once a month? (Bylaws IX, 5 credit committee only) | | | |
| 6. Are all credit committee members usually present? | | | |
| 7. Are loans approved or disapproved within a reasonable time? (Reg.-B-30 days) | | | |
| 8. Are loan practices in compliance with board policies? (Bylaws IX, 8 credit committee only) (701.21(c)(2)) | | | |
| 9. Do loan officers operate with approved limitations? (Bylaws VII, (5)(g)), (IX, 4 credit committee only) | | | |
| 10. Are loan officers minutes submitted within seven days, and are they reviewed by the credit committee? (Bylaws IX, 4 credit committee only) | | | |
| 11. Do different people approve and disburse loans? (Act, 114) | | | |
| 12. Are credit committee alternates used appropriately, and is their use reported to the board? | | | |

| **LOAN DEPT.—COLLECTION DEPT. INTERNAL CONTROLS** | Yes | No | N/A |
|---|---|---|---|
| For use in FCU's with loan and/or collection departments.<br>**NOTE:** A check mark in the gray area MAY indicate a violation of sound internal controls. | | | |
| 1. Are persons who approve or disburse loans denied access to cash and recordkeeping (including access to terminals where loan payments can be changed)? | | | |
| 2. Do supervisors regularly review reports showing: | | | |
| a. Changes in delinquency status? | | | |
| b. Changes in repayment terms? | | | |
| c. Prepaid loans? | | | |
| d. Unusual interest rates? | | | |
| e. Unusual date of first payment? | | | |
| f. Unusually small loan payments? | | | |
| 3. Do supervisors regularly review employees' loans? | | | |
| 4. Are loans assigned consecutive note numbers and recorded in a loan register? | | | |
| 5. Does a supervisor trace a sample of loans back to the minutes? | | | |
| 6. Are loans to staff members approved by credit committee persons or loan officers who are not responsible to them? | | | |
| 7. Are persons who approve or disburse loans denied work in the collection department? | | | |
| 8. Do supervisors periodically review the work of each collector and verify the existence of randomly selected borrowers? | | | |
| 9. Are collectors denied access to cash? | | | |
| 10. Are collectors required to use prenumbered cash received vouchers? | | | |
| 11. Are loan protection insurance claims and payments handled by a supervisor not involved with approving, disbursing, or collecting loans? | | | |
| 12. Is a register of loan protection claims maintained? | | | |

LOAN DEPARTMENT/COLLECTION DEPARTMENT INTERNAL CONTROLS ARE:
SATISFACTORY__ UNSATISFACTORY__

*SEE DISCUSSION ON REVERSE*

---

* References noted as "credit committee only" apply to those credit unions that have eliminated the credit committee. Sound internal controls dictate that loan officers are in compliance with lending policies established by the Board and that loan officer minutes are provided to the board.

## INSTRUCTIONS

1. List established board policies for each type of lending on this form.

2. When specific policies have not been established, enter the actual practice. For example, if there are no policies for used car loans, but such loans are granted; usually for 24 months at 80 percent of book value, enter the actual practices on this form.

3. Enter dollar amounts, months or years, etc.; do not enter "yes" or "no".

4. Retain this form in the examination report for 2 examinations after it is filled.

5. Examiner's are encouraged to use section "k" data when selecting loan samples and making determinations of the extent of loan review in a particular area. When statistics are not available showing the number and dollar amount of commercial loans in the portfolio, then this in itself could be an indication of a potential problem in this area if said loans are material. Likewise, if statictics are not available on variable rate loans and variable rate loans are prevalent, then the examiner needs to determine how funds management is monitored.

6. Definition of a loan concentration—Section 8.5-1 of the examiners guide defines a loan concentration to be the *greater* of $50,000 or 10% of statutory reserves. In the event 10% of statutory reserves exceeds $200,000, all loans over $200,000 will be reviewed. There will of course be instances when examiners will use lesser amounts. The examiner should insert the dollar amount that would be considered a concentration on the last line of section "k".

# LOAN INTERNAL CONTROLS

Charter No. ______________

Examination Date ______________

| **INSIDERS' LOANS** | Yes | No | N/A |
|---|---|---|---|
| 1. Has the board established a processing procedure to assure that income and debt information is complete and to determine total credit union indebtedness of the official (including comaker loans)? (701.21(d)) | | | |
| 2. Are all loans approved by a loan officer or the credit committee? (Bylaws VII or IX whichever is applicable) | | | |
| 3. Are official's loans which result in total indebtedness in excess of $10,000 approved by the board? (701.21 (d)(4)) | | | |
| 4. Are terms for officials the same as for other members? (701.21(d)) | | | |
| 5. Are all approvals recorded on the loan application? (701.21 (c)(3)) | | | |
| **CREDIT COMMITTEE AND/OR LOAN OFFICERS*** | | | |
| 1. Is approval or rejection recorded on loan applications and in the minutes? (Bylaws IX, 3 credit committee only) | | | |
| 2. Are minutes properly prepared, signed, and controlled? (Bylaws IX, 3 credit committe only) | | | |
| 3. Do loan applications contain adequate information to evaluate the borrower's and/or comaker's financial condition? (Bylaws IX, 6 credit committee only), (701.21 (c)(3)) | | | |
| 4. Are the amount and repayment terms consistent with the purpose, ability to repay and collateral of the borrower? (701.21 (c)(4)) | | | |
| 5. Are credit committee meetings held regularly and not less often than once a month? (Bylaws IX, 5 credit committee only) | | | |
| 6. Are all credit committee members usually present? | | | |
| 7. Are loans approved or disapproved within a reasonable time? (Reg.-B-30 days) | | | |
| 8. Are loan practices in compliance with board policies? (Bylaws IX, 8 credit committee only) (701.21(c)(2)) | | | |
| 9. Do loan officers operate with approved limitations? (Bylaws VII, (5)(g)), (IX, 4 credit committee only) | | | |
| 10. Are loan officers minutes submitted within seven days, and are they reviewed by the credit committee? (Bylaws IX, 4 credit committee only) | | | |
| 11. Do different people approve and disburse loans? (Act, 114) | | | |
| 12. Are credit committee alternates used appropriately, and is their use reported to the board? | | | |

| **LOAN DEPT.—COLLECTION DEPT. INTERNAL CONTROLS** | Yes | No | N/A |
|---|---|---|---|
| For use in FCU's with loan and/or collection departments.<br>**NOTE:** A check mark in the gray area MAY indicate a violation of sound internal controls.<br>1. Are persons who approve or disburse loans denied access to cash and recordkeeping (including access to terminals where loan payments can be changed)? | | | |
| 2. Do supervisors regularly review reports showing: | | | |
| a. Changes in delinquency status? | | | |
| b. Changes in repayment terms? | | | |
| c. Prepaid loans? | | | |
| d. Unusual interest rates? | | | |
| e. Unusual date of first payment? | | | |
| f. Unusually small loan payments? | | | |
| 3. Do supervisors regularly review employees' loans? | | | |
| 4. Are loans assigned consecutive note numbers and recorded in a loan register? | | | |
| 5. Does a supervisor trace a sample of loans back to the minutes? | | | |
| 6. Are loans to staff members approved by credit committee persons or loan officers who are not responsible to them? | | | |
| 7. Are persons who approve or disburse loans denied work in the collection department? | | | |
| 8. Do supervisors periodically review the work of each collector and verify the existence of randomly selected borrowers? | | | |
| 9. Are collectors denied access to cash? | | | |
| 10. Are collectors required to use prenumbered cash received vouchers? | | | |
| 11. Are loan protection insurance claims and payments handled by a supervisor not involved with approving, disbursing, or collecting loans? | | | |
| 12. Is a register of loan protection claims maintained? | | | |

LOAN DEPARTMENT/COLLECTION DEPARTMENT INTERNAL CONTROLS ARE:
SATISFACTORY__ UNSATISFACTORY__

*SEE DISCUSSION ON REVERSE*

* References noted as "credit committee only" apply to those credit unions that have eliminated the credit committee. Sound internal controls dictate that loan officers are in compliance with lending policies established by the Board and that loan officer minutes are provided to the board.

(Rev. 6/86) NCUA 2265

## PURPOSE OF FORM

1. A "No" answer in either the Insiders' Loans or Credit Committee-Loan Officers sections will usually indicate a violation of the Act, Rules and Regulations or Bylaws.

2. The purpose of identifying violations is more to affect corrective action than to list past errors.

3. A "No" answer in the "Loan Department-Collection Department internal Controls" section MAY indicate a violation of sound internal controls. Each credit union has differing needs and capabilities in this area; judgment is necessary to determine when a "No" answer needs further attention. Some credit unions maye have one "No", and the examiner will rate internal controls. "Unsatisfactory". Another credit union may have several "No's", but the examiner may conclude that internal controls are "Satisfactory" for that credit union. The questions are not all inclusive; they are merely a tool to use in evaluating the internal controls.

## DISCUSSION OF INTERNAL CONTROL QUESTIONS

1. Persons who approve or disburse loans should be denied access to cash and records to segregate duties as much as possible so that the work of one proves the work of another.

2. Supervisors should regularly review changes in loan items, prepayments and unusual items to prevent unauthorized changes, or "hidden" delinquency, or preferential treatment (possibly illegal) to friends or family of subordinates. Also, supervisors should know what all of their subordinates are doing.

3. Supervisors should review employee's loans to prevent any possible abuses in this sensitive area.

4. Sequential note numbers ensure that all loans are recorded and can be reviewed for propriety and completeness.

5. Tracing some loans back to the minutes ensure that the loans were approved, and that they were disbursed as approved.

6. Loans to supervisors should not be approved by subordinates who may feel pressured to approve a questionable loan.

7. Persons who approve and disburse loans should not work in collections to segregate duties, and to prevent the granting of a ficticious loan that cannot be collected.

8. Supervisors should be aware of what subordinates are doing, and should ensure that collectors are "working" active loans to prevent possible fraud.

9. Collectors who handle cash could be tempted to keep payments and claim such payments were not made.

10. Pre-numbered cash received vouchers are not as good as complete segregation of duties, but help as in 9 above.

11. Loan protection claims filed on non-existent borrowers are one way that funds have been stolen from credit unions.

12. See 11 above.

REMOVE THIS PIECE BEFORE ASSE

## LOAN PROFILE

CHARTER NO. ____________

Examination Date ____________

COLLATERAL CODES

| | | |
|---|---|---|
| 1. Unsecured | 5. Comaker | 9. Household Goods |
| 2. Share Secured | 6. Boat | 10. Insr., Stock, Etc. |
| 3. New Vehicle | 7. Business/Farm Equip. | 11. Student |
| 4. Used Vehicle | 8. Real Estate | 12. Other |

PURPOSE CODES

| | |
|---|---|
| 1. Pay Bills | 5. Taxes, Xmas |
| 2. Not Stated | 6. Boat |
| 3. New Vehicle | 7. Business/Far |
| 4. Used Vehicle | 8. Real Estate |

DEBT RATIO: NET ☐ (N)
GROSS ☐ (G)

| | ☐ Review ☐ Profile REFERENCE AND OPTIONAL | LOAN CHARACTERISTICS | | | | | | | | | | | | | | BORROWER CHARACTERISTICS | | | | | | | | | OPTIONAL | | | | | | | | HIGH RISK |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Out-standing Amt. | Date of Loan | Original Amt. of Loan | TYPE | | | MATURITY | | | | | | Collateral | Purpose | JOB SENIORITY | | | | | DEBT RATIO | | | | HOUSING | | | | CREDIT REPORTS | | APPROVED BY | | |
| | | | | | L | C | R | 12 or less | 13-24 | 25-48 | 49-119 | 120-143 | Over 144 Specify | | | Under 1 | 1-2 | 2-5 | 5-10 | Over 10 | < 15 G < 35 N Low | 15-35 G 35-55 N Med | 35+ G 55+ N High | Problem | R | O | B | Optional | Yes | No | CC | Initials of L/O | |
| 1 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 7 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 8 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 9 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 10 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 11 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 12 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 13 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 14 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 15 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 16 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 17 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 18 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 19 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 20 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 21 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 22 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 23 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 24 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 25 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 26 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 27 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 28 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 29 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 30 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 31 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 32 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

☆ U.S. GOVERNMENT PRINTING OFFICE : 1981—522-648

REMOVE THIS PIECE BEFORE ASSEMBLING INTO EXAMINATION REPORT

PURPOSE CODES

1. Pay Bills
2. Not Stated
3. New Vehicle
4. Used Vehicle
5. Taxes, Xmas, Vacation
6. Boat
7. Business/Farm Equip.
8. Real Estate
9. Household Goods
10. Investment
11. Student
12. Other
13. Home Improvements

| WER CHARACTERISTICS | | | | | | | OPTIONAL | | | | | | | | HIGH RISK | COMMENTS AND FOR OPTIONAL USE |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| NIORITY | | | DEBT RATIO | | | | HOUSING | | | | CREDIT REPORTS | | APPROVED BY | | | |
| 2-5 | 5-10 | Over 10 | < 15 G < 35 N Low | 15-35 G 35-55 N Med | 35+ G 55+ N High | Problem | R | O | B | Optional | Yes | No | CC | Initials of L/O | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |

(Rev. 12/81) NCUA 2270

# LOAN PROFILE

CHARTER NO. ____________

Examination Date ____________________

COLLATERAL CODES

1. Unsecured
2. Share Secured
3. New Vehicle
4. Used Vehicle
5. Comaker
6. Boat
7. Business/Farm Equip.
8. Real Estate
9. Household Goods
10. Insr., Stock, Etc.
11. Student
12. Other

PURPOSE CODES

1. Pay Bills
2. Not Stated
3. New Vehicle
4. Used Vehicle
5. Taxes, Xmas, Vacation
6. Boat
7. Business/Farm Equip.
8. Real Estate
9. Household Goods
10. Investment
11. Student
12. Other
13. Home Improvements

| | DEBT RATIO: NET ☐ (N) GROSS ☐ (G)<br>☐ Review ☐ Profile<br>REFERENCE AND OPTIONAL | LOAN CHARACTERISTICS | | | | | | | | | | | | | | BORROWER CHARACTERISTICS | | | | | | | | | OPTIONAL | | | | | | | | HIGH RISK | COMMENTS AND FOR OPTIONAL USE |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Out-standing Amt. | Date of Loan | Original Amt. of Loan | TYPE | | | MATURITY | | | | | | Collateral | Purpose | JOB SENIORITY | | | | | DEBT RATIO | | | | HOUSING | | | | CREDIT REPORTS | | APPROVED BY | | | |
| | | | | | L | C | R | 12 or less | 13-24 | 25-48 | 49-119 | 120-143 | Over 144 Specify | | | Under 1 | 1-2 | 2-5 | 5-10 | Over 10 | 15 G 35 N Low | 15-35 G 35-55 N Med | 35+ G 55+ N High | Problem | R | O | B | Optional | Yes | No | CC | Initials of L/O | | |
| 33 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 34 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 35 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 36 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 37 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 38 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 39 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 40 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 41 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 42 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 43 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 44 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 45 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 46 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 47 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 48 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 49 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 50 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

## GUIDELINES

Outstanding Amount – dollars only.

Date of Loan – date loan or latest advance was granted.

Original Amount of Loan – the approved credit line can be entered for line of credit loans.

Type – line of credit or open end L, closed end C, or refinanced R.

Maturity – the appropriate maturity.

Collateral and Purpose codes – the codes provided should be used in all cases. Additional codes may be added, however, codes are used to determine the most common, and second most common characteristics. A unique type of loan need not be coded.

Job Seniority – number of years with present employer. For military personnel, the total time with the military. For labor unions, years of union affiliation. Retirees as "R", and unemployed persons as "U".

Debt Ratio – compute and enter the total debt ratio. Also, whether the net income or gross income is used for calculations. The debt ratio is the total income (either net or gross) divided into total expenses. The debt ratio should be computed using the income the applicant states is available, and with the obligations shown. A spouse's income does not affect the debt ratio unless that income is shown as relied upon to repay the obligation.

Optional – for examiner use.

a. Housing – Rent R, Owns O, and Buying B.
 Optional column for military residence, living with parents, etc.

b. Credit Reports – Yes or No.

c. Approved By – Either a check under the C/C heading, or the initials under the L/O heading be entered.

High Risk – Check to identify high risk loans.

Comments and for Optional Use – As needed.

REMOVE THIS PIECE BEFORE ASSEMBLING INTO EXAMINATION REPORT

## LARGE/REAL ESTATE LOAN PROFILE

**CHARTER NO.** ____________

**Examination Date** ____________

| | | | | | | | | 30 YEAR REAL ESTATE | | | | | | | | OPTIONAL USE | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | REFERENCE AND OPTIONAL | Unpaid Balance | Date of Loan | Original Amount of Loan | Maturity | Appr. Value of Collateral | Securities Pwr. of Atty. | Loan Applic. | Written Apprai. | Priv. Mtg. Ins. | Settle. State. (HUD-1) | Curr. Haz. Ins. | Flood Ins. | Note & Sec. Instru. | Median Sales State. | Title Insr. Opinion | Notice of Recission | | | | | COMMENTS - OPTIONAL |
| 1 | | | | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | | | | | | | | | |
| 7 | | | | | | | | | | | | | | | | | | | | | | |
| 8 | | | | | | | | | | | | | | | | | | | | | | |
| 9 | | | | | | | | | | | | | | | | | | | | | | |
| 10 | | | | | | | | | | | | | | | | | | | | | | |
| 11 | | | | | | | | | | | | | | | | | | | | | | |
| 12 | | | | | | | | | | | | | | | | | | | | | | |
| 13 | | | | | | | | | | | | | | | | | | | | | | |
| 14 | | | | | | | | | | | | | | | | | | | | | | |
| 15 | | | | | | | | | | | | | | | | | | | | | | |
| 16 | | | | | | | | | | | | | | | | | | | | | | |
| 17 | | | | | | | | | | | | | | | | | | | | | | |
| 18 | | | | | | | | | | | | | | | | | | | | | | |
| 19 | | | | | | | | | | | | | | | | | | | | | | |
| 20 | | | | | | | | | | | | | | | | | | | | | | |
| 21 | | | | | | | | | | | | | | | | | | | | | | |
| 22 | | | | | | | | | | | | | | | | | | | | | | |
| 23 | | | | | | | | | | | | | | | | | | | | | | |
| 24 | | | | | | | | | | | | | | | | | | | | | | |
| 25 | | | | | | | | | | | | | | | | | | | | | | |
| 26 | | | | | | | | | | | | | | | | | | | | | | |
| 27 | | | | | | | | | | | | | | | | | | | | | | |
| 28 | | | | | | | | | | | | | | | | | | | | | | |
| 29 | | | | | | | | | | | | | | | | | | | | | | |
| 30 | | | | | | | | | | | | | | | | | | | | | | |
| 31 | | | | | | | | | | | | | | | | | | | | | | |
| 32 | | | | | | | | | | | | | | | | | | | | | | |
| 33 | | | | | | | | | | | | | | | | | | | | | | |
| 34 | | | | | | | | | | | | | | | | | | | | | | |
| 35 | | | | | | | | | | | | | | | | | | | | | | |
| 36 | | | | | | | | | | | | | | | | | | | | | | |

(Rev. 12/81) NCUA 2280

| | | | | | | | | 30 YEAR REAL ESTATE | | | | | | | | OPTIONAL USE | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | REFERENCE AND OPTIONAL | Unpaid Balance | Date of Loan | Original Amount of Loan | Maturity | Appr. Value of Collateral | Securities Pwr. of Atty. | Loan Applic. | Written Apprais. | Priv. Mtg. Ins. | Settle. State. (HUD-1) | Curr. Haz. Ins. | Flood Ins. | Note & Sec. Instru. | Median Sales State. | Title Insr. Opinion | Notice of Recision | | | | | COMMENTS - OPTIONAL |
| 37 | | | | | | | | | | | | | | | | | | | | | | |
| 38 | | | | | | | | | | | | | | | | | | | | | | |
| 39 | | | | | | | | | | | | | | | | | | | | | | |
| 40 | | | | | | | | | | | | | | | | | | | | | | |
| 41 | | | | | | | | | | | | | | | | | | | | | | |
| 42 | | | | | | | | | | | | | | | | | | | | | | |
| 43 | | | | | | | | | | | | | | | | | | | | | | |
| 44 | | | | | | | | | | | | | | | | | | | | | | |
| 45 | | | | | | | | | | | | | | | | | | | | | | |
| 46 | | | | | | | | | | | | | | | | | | | | | | |
| 47 | | | | | | | | | | | | | | | | | | | | | | |
| 48 | | | | | | | | | | | | | | | | | | | | | | |
| 49 | | | | | | | | | | | | | | | | | | | | | | |
| 50 | | | | | | | | | | | | | | | | | | | | | | |
| 51 | | | | | | | | | | | | | | | | | | | | | | |
| 52 | | | | | | | | | | | | | | | | | | | | | | |
| 53 | | | | | | | | | | | | | | | | | | | | | | |
| 54 | | | | | | | | | | | | | | | | | | | | | | |
| 55 | | | | | | | | | | | | | | | | | | | | | | |
| 56 | | | | | | | | | | | | | | | | | | | | | | |
| 57 | | | | | | | | | | | | | | | | | | | | | | |
| 58 | | | | | | | | | | | | | | | | | | | | | | |
| 59 | | | | | | | | | | | | | | | | | | | | | | |
| 60 | | | | | | | | | | | | | | | | | | | | | | |

## GUIDELINES

(1) *Appraised value of Collateral*—Record stock/securities quotations, appraised value of real estate, etc.

(2) *Securities Power of Attorney*—Check mark to indicate that the credit union has the legal right to convert securities to cash.

(3) *Optional*—For examiner use: When used, Check to indicate the loan file contains the appropriate documents.

☆ U.S.GPO:1984-0-451-251/18550

## INSIDERS' LOANS

Charter No. ________________

Examination Date ______________

| | LIST | | | REVIEW | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | REFERENCE AND TITLE | SHARES | Outstanding Amt. | Date of Loan | Original Amt. of Loan | Properly Approved | | VALUE OF COLLAT. | COMMENTS/OPTIONAL |
| | | | | | | Yes | No | | |
| 1 | | | | | | | | | |
| 2 | | | | | | | | | |
| 3 | | | | | | | | | |
| 4 | | | | | | | | | |
| 5 | | | | | | | | | |
| 6 | | | | | | | | | |
| 7 | | | | | | | | | |
| 8 | | | | | | | | | |
| 9 | | | | | | | | | |
| 10 | | | | | | | | | |
| 11 | | | | | | | | | |
| 12 | | | | | | | | | |
| 13 | | | | | | | | | |
| 14 | | | | | | | | | |
| 15 | | | | | | | | | |
| 16 | | | | | | | | | |
| 17 | | | | | | | | | |
| 18 | | | | | | | | | |
| 19 | | | | | | | | | |
| 20 | | | | | | | | | |

1. Total outstanding balances of insider's loans. $__________
2. Ratio of insiders' loans to total loans. __________%
3. Average balance of insiders' loans. $__________
   (Relate this average balance to the average balance of loans to all members.)
4. When appropriate in the examiner's judgement, extend this analysis to determine the average amount granted to insiders with relation to the average amount granted to all members. $__________insiders $_______all members

CONTINUED ON REVERSE

| | LIST | | | REVIEW | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | REFERENCE AND TITLE | SHARES | Outstanding Amt. | Date of Loan | Original Amt. of Loan | Properly Approved | | VALUE OF COLLAT. | COMMENTS/OPTIONAL |
| | | | | | | Yes | No | | |
| 21 | | | | | | | | | |
| 22 | | | | | | | | | |
| 23 | | | | | | | | | |
| 24 | | | | | | | | | |
| 25 | | | | | | | | | |
| 26 | | | | | | | | | |
| 27 | | | | | | | | | |
| 28 | | | | | | | | | |
| 29 | | | | | | | | | |
| 30 | | | | | | | | | |
| 31 | | | | | | | | | |
| 32 | | | | | | | | | |
| 33 | | | | | | | | | |
| 34 | | | | | | | | | |
| 35 | | | | | | | | | |
| 36 | | | | | | | | | |
| 37 | | | | | | | | | |
| 38 | | | | | | | | | |
| 39 | | | | | | | | | |
| 40 | | | | | | | | | |

# LINES OF CREDIT—CREDIT CARDS

Charter No. ____________

Examination Date ____________

**NOTE: A check mark in a gray area MAY indicate a violation of sound internal controls.**

| **LINES OF CREDIT** Sound Credit Extension | Yes | No | N/A |
|---|---|---|---|
| 1. Is the agreement on file approved by the credit committee or loan officer? | | | |
| 2. Are there separate agreements if a member has more than one account? | | | |
| 3. Does the agreement contain: | | | |
| a. Maximum limit? | | | |
| b. Repayment terms? | | | |
| c. Interest rate? | | | |
| d. A promise to pay? | | | |
| e. Provision for prepayment without penalty? | | | |
| f. Conditions or terms of termination? | | | |
| 4. Is the agreement reviewed periodically and is this documented in the member's loan folder? | | | |
| 5. Is a reapplication required whenever the credit limit is increased or terms of repayment of the original agreement are extended? | | | |
| 6. Is there a policy for controlling advances in excess of the approved limit? | | | |
| 7. Does the board of directors make a monthly review of liquidity and document the following in their minutes? | | | |
| a. The number and amount of outstanding balances of line of credit agreements? | | | |
| b. The aggregate amount of credit approved under line of credit agreements? | | | |
| c. The amount of loans advanced and repaid under line of credit agreements during the previous month? | | | |
| 8. Do applications contain sufficient information to determine the applicant's financial responsibility? | | | |

LINES OF CREDIT PROCEDURES ARE:

SATISFACTORY [ ] UNSATISFACTORY [ ]

| **CREDIT CARD INTERNAL CONTROLS** | Yes | No | N/A |
|---|---|---|---|
| 1. If cards are embossed and mailed to members by an "outside" company, does the credit union maintain a register of cards ordered? | | | |
| a. Do credit union personnel verify cards issued against the register of cards ordered? | | | |
| 2. If the cards are embossed and mailed to members by the credit union: | | | |
| a. Is there a register showing cards ordered, received, embossed and mailed? | | | |
| b. Is the supply of "blank" cards under dual control? | | | |
| c. Are the "blank" cards periodically inventoried by supervisory personnel? | | | |
| d. Are the embossing machines and keys under dual control? | | | |
| e. Is there a register for spoiled and returned cards? | | | |
| f. Is destruction of cards done only under dual control? | | | |

| **CREDIT CARD INTERNAL CONTROLS (cont.)** | Yes | No | N/A |
|---|---|---|---|
| g. Are cards mailed in envelopes that do not disclose their contents? | | | |
| 3. Is a completed application obtained from each potential card holder? | | | |
| 4. Are procedures in effect to control the number of credit card-accessed lines of credit opened for one member? | | | |
| 5. Are insiders' accounts reviewed periodically by an auditor or supervisory committee? | | | |
| 6. Does the board of directors have written credit card policies which: | | | |
| a. Establish procedures for reviewing credit card applications? | | | |
| b. Establish standards for determining credit limits? | | | |
| 7. **Credit Card Records** | | | |
| a. Are totals from the processor's daily transaction register posted to the JCR each day? | | | |
| b. Are exceptions (unapplied transactions) corrected each day? | | | |
| c. Does the credit union reconcile monthly G/L totals with processor totals? | | | |
| d. Is a periodic report produced and reviewed by management regarding: | | | |
| (1) Any changes to the credit union's control files (records which contain all of the parameters and options which control the credit card processing program)? | | | |
| (2) Any changes to individual card holder authorization parameters? | | | |
| (3) Any changes (i.e. extensions, renewals) to an individual cardholder's account which would affect the status of the account? | | | |
| e. Is a delinquent accounts report generated at least monthly? | | | |
| 8. Are payment schedules on lines of credit accessed by credit cards sufficient to repay advances in a reasonable period in order to assure that sufficient funds are available for liquidity needs? | | | |
| 9. If the credit union has entered into an agency relationship with another institution, does the credit union: | | | |
| a. Retain the right to make its own credit decisions on each member's credit application, including the right to terminate the line of credit after approval? | | | |
| b. Own 100% of the loans made to its members under the credit card program? | | | |

CREDIT CARD PROCEDURES ARE:

SATISFACTORY [ ] UNSATISFACTORY [ ]

COMMENTS: ____________

## COMMERCIAL LOAN CHECKLIST

Charter No. ____________________

Examination Date ____________________

BORROWER
LOAN DATE
ORIGINAL AMOUNT
UNPAID BALANCE

TYPE OF LOAN

LOAN TERMS

| | YES | NO | N/A |
|---|---|---|---|
| 1. LOAN PAYMENT RELIES ON BUSINESS REVENUE | | | |
| 2. SECURITY IS BUSINESS ASSETS | | | |
| 3. PURPOSE WAS TO OBTAIN A BUSINESS OR BUSINESS ASSETS | | | |
| 4. PROCEEDS FINANCED BUSINESS OPERATIONS | | | |

If any of the above questions were answered yes, then you have a business loan.

If any of the following questions are answered no, then you have substandard lending.

| | YES | NO | N/A |
|---|---|---|---|
| 1. THE NOTE WAS PROPERLY EXECUTED AND RECORDED | | | |
| 2. THE SECURITY AGREEMENT WAS PROPERLY EXECUTED AND RECORDED | | | |
| 3. THE CONTRACTS WERE PROPERLY EXECUTED AND RECORDED | | | |
| 4. LIENS WERE PROPERLY FILED/RECORDED | | | |
| 5. SUFFICIENT CASUALTY/LIFE INSURANCE WAS IN FORCE | | | |
| 6. LOAN APPLICATION REVEALED | | | |
| A. AMOUNT | | | |
| B. PURPOSE | | | |
| C. BORROWER'S SIGNATURE | | | |
| 7. LOAN OFFICER NARRATIVE REVEALED | | | |
| A. APPROVAL OR DENIAL | | | |
| B. LIMITATIONS ON APPROVAL | | | |
| C. OVERALL HISTORY OF BORROWER | | | |
| 8. BORROWER'S LEGAL FORM OF ORGANIZATION WAS DOCUMENTED | | | |
| 9. PRINCIPALS IN BUSINESS WERE IDENTIFIED | | | |
| 10. COMPLETE FINANCIAL STATEMENTS WERE IN FILE WITH SUPPORTING SCHEDULES AND TAX RETURNS | | | |
| 11. LOAN OFFICER/COMMITTEE ANALYSIS WAS DOCUMENTED | | | |
| A. CREDIT REPORT | | | |
| B. RATIO AND TREND ANALYSIS | | | |
| C. INTERNAL COMPARISON | | | |
| D. EXTERNAL COMPARISON | | | |
| E. PRO FORMA STATEMENTS | | | |
| F. MAJOR ASSETS AND LIABILITIES VERIFIED | | | |
| 12. BUSINESS AUTHORIZATION TO BORROW/ENCUMBER ASSETS WAS DOCUMENTED | | | |
| 13. COLLATERAL CONDITIONS AND VALUE WAS DETERMINED BY INDEPENDENT APPRAISER QUALIFIED TO APPRAISE THE COLLATERAL | | | |
| 14. PERIODIC REVIEW OF FINANCIAL CONDITION AND COLLATERAL IS DOCUMENTED | | | |

(Rev. 6/86) NCUA 2296

## LARGE LOANS/CONCENTRATIONS

Charter No. ____________

| | REFERENCE AND OPTIONAL | Date of Loan | Original Amount of Loan | UNPAID BALANCES AS OF EXAMINATION DATE | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 7 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 8 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 9 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 10 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 11 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 12 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 13 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 14 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 15 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 16 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 17 | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| | EXAMINATION DATES | ▨ | ▨ | | | | | | | | | |

See Instructions on Reverse

(Rev. 10/82) NCUA 2300

# INSTRUCTIONS

This is a permanent form. Retain it in the current examination report until the final disposition of all of the large loans on the form.

☆ U. S. GOVERNMENT PRINTING OFFICE : 1982 261-826/45

# COLLECTION PROGRAM

Charter No. ____________

Examination Date ______________________

| | Yes | No | N/A |
|---|---|---|---|
| 1. Are accurate determinations of delinquency made? | | | |
| 2. Does the board regularly review delinquency reports? | | | |
| 3. Does the board analyze the credit union's delinquency, loss ratio, liquidity and reserve position in relationship to one another? | | | |
| 4. Is the Allowance for Loan Losses adequate? | | | |
| 5. Is the allowance account adjusted regularly? | | | |
| 6. Are revisions to lending policies made to control delinquency? | | | |
| 7. Are steps taken to ensure that collection is made on insured loans? (Disability, death, non-filing, etc.) | | | |
| 8. Are in-house collection personnel trained and experienced in collections? | | | |
| 9. Does management allocate sufficient time for collectors to properly function? | | | |
| 10. Is the collection department staffed for after-hours and weekend contacts? | | | |
| 11. Are formal policies in place to determine when legal action, repossession, professional placement and charge-off will occur? | | | |
| 12. Does management periodically review the workload/performance of the collection department? | | | |
| 13. Are timely initial and follow-up contacts made? | | | |
| 14. Are collection cards established for each delinquent account? | | | |
| 15. Are follow-ups made on all promises for payment? | | | |
| 16. Are skip traces checked with all possible sources? | | | |
| 17. Do tellers have "want lists" of delinquent borrowers? | | | |
| 18. Are debts to be discharged in a bankruptcy checked against those listed by the borrower? | | | |
| 19. Are legal actions, including repossessions, taken on a timely basis? | | | |
| 20. Are cosigners contacted early in the collection process? | | | |
| 21. Are terminating employees provided with exit interviews and payment coupon books? | | | |
| 22. Is counseling routinely offered and provided to borrowers who are responsive, yet continually delinquent? | | | |
| 23. Are extension and refinance policies designed to avoid future delinquency? | | | |
| 24. Is small claims court used when permissible? | | | |
| 25. Do all outside collectors provide periodic progress reports? | | | |

See discussion on reverse.

## DISCUSSION

1. The method of determining delinquency must be accurate, and must neither understate nor overstate delinquency. EDP methods must also be checked to ensure accurate programming.

2. The board has the final responsibility for the management of the credit union; accurate data is necessary for adequate management.

3. In addition to the delinquency figures, the board must consider the effects of delinquency. Delinquent loans reduce cash flow and income, could put the credit union into a higher reserving category, reduce available reserves through losses and can lead to insolvency.

4. The Allownace for Loan Losses must have a sufficient balance to provide for potential ioss loans.

5. The allowance account must be adjusted at the end of each accounting period, prior to the declaration and payment of any dividend.

6. Lending policies need to be adjusted to minimize losses in areas of greatest exposure. If frequent losses occur as a result of deficiency balances or unsecured loans policies can increase collateral requirements or reduce the signature limit.

7. All collection efforts should be exhausted prior to placing the loan with an outside collector; including reviewing the files for potentially applicable insurances.

8. Staff should be continually developed by training. When severe problems exist, only experienced staff should be hired/used for collections.

9. Management can not disrupt the collection effort by continually re-establishing priorities.

10. Collection contacts must often be made in the evenings or on weekends; the collection department should be staffed at those times when problems exist.

11. Formal policies should outline the time frames for all routine collection department activity.

12. Management should ensure that staff and facilities are appropriate to meet established goals and objectives; and that goals and objectives are reached.

13. Initial contacts should be made within a few days of a missed payment; follow-up contacts should be within a few days of the initial contact.

14. Collection cards should be established to record collection efforts, payments, promises and collateral.

15. Follow-ups on failed promises should be made within a day or two of the promised date.

16. Skips should be traced with relatives, friends, coworkers, known creditors, the Postal Service, the Department of Motor Vehicles and/or the Social Security Administration.

17. Tellers should alert the collection department when delinquent borrowers are in the office.

18. Debts to be discharged in bankruptcy proceedings should be checked against the borrower's listed debts on the application to determine if fraud is involved.

19. Legal actions, ideally, should occur neither too soon (thus affecting the amount the credit union will collect) nor too late (thus affecting the collectability of the debt).

20. Cosigners can often become the credit union's best collectors if they realize they will have to pay.

21. Exit interviews should be held to firmly establish payment responsibility with the borrower, and payment coupons should be provided to act as a reminder.

22. The credit union should help the borrower make payments by providing expert financial counseling.

23. Extension and refinance policies often compound a problem by pyramiding debts. Such policies should minimize new money and stress timely payments.

24. Small claims court can serve as a cost effective method of collecting small accounts.

25. Outside collectors should provide progress reports on a scheduled basis to report the status of all accounts. Collectors should be changed if it appears they work only the accounts easiest to collect.

Control No. (Agency use only) ______________________

Page 1 of 7
OMB No. 3133-0094

# CRIMINAL REFERRAL FORM

**Attention:** This form should be filed by the reporting credit union not later than 7 business days following the discovery of the suspected violation. Additional information not readily available at the time of filing should be submitted on an amended form.

One copy of the completed form should be filed with each of the following: (1) the local U.S. Attorney, (2) the local FBI office, and (3) the National Credit Union Administration (NCUA) Regional Office where the credit union is located.

**Complete only pages one and two if suspected criminal activity involves actual or probable loss of less than $10,000** (before any recovery of reimbursement) not involving an elected or appointed official within the meaning of 12 U.S.C. Section 1761 or an employee of the credit union. Criminal activity involving less than $2,500 per transaction need not be reported *unless* the name of the suspect is known or it is reasonably believed that the suspect can be identified. In all cases, regardless of amount, a report should be submitted if the name of the suspect is known.

**Complete all items on this form where suspected criminal activity involves actual or probable loss (before reimbursement or recovery) of $10,000 or greater and in all cases, regardless of the amount, involving an elected or appointed official as defined by Section 111 of the Federal Credit Union Act (12 U.S.C. Section 1761) or an employee of the credit union.** For purposes of this form, "suspected criminal activity" is anything for which there is a factual basis for believing that a crime has occurred.

The NCUA Board considers this report confidential pursuant to applicable provisions of the Privacy Act, 5 U.S.C. Section 552a, and the Freedom of Information Act, 5 U.S.C. Section 552. Accordingly, the report and the information that it contains may be shared with appropriate law enforcement agencies consistent with applicable laws and regulations. In addition, persons identified in the report may in some circumstances be entitled to access to the report under provisions of the Privacy Act. **In no case should information in this report be disclosed by a credit union official or employee to any source (except a law enforcement agency) or person not specifically designated for distribution on this form.**

**See Detailed Instructions on Page 6**

[redacted]

1. **Name, location, and charter or insurance certificate number of credit union.**

Name ______________________________

Location ______________________________
Street City State Zip

Charter/insurance certificate number ______________

If activity occurred at branch office(s), please identify: ______________________________

______________________________

2. **Asset size of credit union** (millions of dollars) ______________

3. **Approximate date and dollar amount (prior to any allowance for restitution or recovery) of suspected violation.**

Date ______________ Amount (thousands of dollars) $ ______________
Month Day Year

4. **Summary characterization of the suspected violation. Check appropriate box(es)**

☐ Defalcation/Embezzlement
☐ False Statement
☐ Check Kiting
☐ Other (Describe) ______________________________
☐ Bribery/Gratuity
☐ Misuse of Position or Self-Dealing
☐ Mysterious Disappearance

Applicable Section(s) of Title 18, U.S. Code (if known). (See list on page 7.) ______________

5. **This matter is being referred to the FBI in** ______________________________
City State

**and the U.S. Attorney in** ______________________________ ______________________________
City State Judicial District (if known)

Name of Financial Institution

6. **Person(s) Suspected of Criminal Violation** (if more than one, use continuation sheet)

a. Name ______ First ______ MI ______ Last

Address ______ Street ______ City ______ State ______ Zip Code

Date of Birth ______ Month Day Year Social Security No. (if known) ______

b. Relationship to the financial institution (check all applicable blocks)

☐ Officer ☐ Employee ☐ Broker ☐ Shareholder

☐ Director ☐ Agent ☐ Borrower ☐ Other (specify) ______

c. Is person still affiliated with the financial institution ☐ Yes ☐ No

If no, ☐ terminated ☐ resigned Date ______ Month Day Year

Describe Circumstances of Separation (if necessary, use continuation sheet) ______

d. Prior or related referrals ☐ Yes ☐ No If yes, please identify briefly by name and date.

e. Is person affiliated with any other financial institution ☐ Yes ☐ No or business enterprise. ☐ Yes ☐ No If yes to either or both, please identify.

[redacted]

7. **Explanation/Description of Suspected Violation.** (Give a brief summary of the suspected violation, explaining what is unusual or irregular about the transaction.) (if necessary, use continuation sheet)

8. **Has there been a confession?** ☐ Yes ☐ No. If so, by whom? ______

9. **Offer of Assistance.** The individuals listed below are/will be authorized to discuss this referral with FBI and Department of Justice officials and to assist in locating or explaining any documents pertinent to this referral, provided that contact is first made with

Name ______ Position ______

Telephone ______

Name ______ Telephone ______

Name ______ Telephone ______

Name ______ Telephone ______

10. **Form Prepared by** ______

Position ______

Agency/Institution ______

Telephone ______ Date ______

**Complete the remaining questions if suspected criminal activity involves probable loss (before reimbursement or recovery) of $10,000 or greater and in all cases, regardless of amount, involving an elected or appointed official within the meaning of 12 U.S.C. Section 1761 or an employee of the credit union.**

11. **Give a Chronological and Complete Account of the Suspected Violation.** (if necessary, use continuation sheet)

- Relate key events to documents and attach copies of those documents.
- Explain who benefited, financially or otherwise, from the transaction, how much, and how.
- Furnish any explanation of the transaction provided by the suspect and indicate to whom and when it was given.
- Furnish any explanation of the transaction provided by any other person.
- Indicate where the suspected violation took place (e.g., main office, branch, other).
- Recommend any further investigation that might assist law enforcement authorities in fully examining the potential violation.

12. **Indicate Whether the Suspected Violation Appears to Be an Isolated Incident or Whether It Relates to Other Transactions.** (Explain)

Name of Financial Institution

13. **Exclusion of Information from the Referral.** Has any pertinent information been excluded from this referral as a result of any legal or other restraint? ☐ Yes ☐ No.

If so, why? ______

Have the excluded information or documents been segregated for later retrieval? ☐ Yes ☐ No.

14. **Witnesses.** List any witness who might have information about the suspected violation and describe their position or employment. Indicate if they have been interviewed. (if necessary, use continuation sheet)

| | *Name* | *Position* | *Address* | *Telephone* | *Interviewed* Yes | *Interviewed* No |
|---|---|---|---|---|---|---|
| 1. | | | | | ☐ | ☐ |
| 2. | | | | | ☐ | ☐ |
| 3. | | | | | ☐ | ☐ |
| 4. | | | | | ☐ | ☐ |
| 5. | | | | | ☐ | ☐ |

15. **Discovery and Reporting**
   a. Who discovered the suspected violation and when?

   b. Has the suspected violation been reported to the Board of Directors? ☐ Yes ☐ No By whom and when?

   c. Has the Board of Directors taken action? ☐ Yes ☐ No If so, what and when?

   d. Has the suspected violation previously been reported to federal or local law enforcement or to any federal or state supervisory agency? ☐ Yes ☐ No If so, by whom, to whom, and when?

16. **Loss**
   a. Amount of loss known $ ______
   b. Restitution by ______
   In the amount of $ ______
   c. Name of Applicable Surety Bond Company ______
   d. Amount of Bond $ ______
   e. Amount of deductible $ ______
   f. Was claim filed? ☐ Yes ☐ No ______
   g. Settlement by Surety company to date $ ______
   h. Total restitution and settlement to date $ ______
   i. Net loss (after subtracting any amounts paid in the form of restitution of settlement) $ ______
   j. Is additional loss suspected? ☐ Yes ☐ No (If yes, explain)

   k. Has the suspected violation had a material impact on or otherwise affected the financial soundness of the institution?
   ☐ Yes ☐ No (If yes, explain)

Name of Financial Institution

## Continuation Sheet

| Item No. | Remarks |
|---|---|
| | |

## PRINCIPAL CRIMINAL STATUTES

| | |
|---|---|
| **18 U.S.C. 2** | "To aid, abet, counsel, command, induce or procure" the commission of federal offense. |
| **18 U.S.C. 201** | Bribery of "public officers," including elected representatives, jurors and employees of any department or agency of the federal government, and witnesses in official proceedings, e.g., anyone who gives, offers or promises anything of value to a public official or a witness with the intent to influence that person's official functions. |
| **18 U.S.C. 215** | Kickbacks, bribes. Makes it unlawful for any officer, director, employee, agent or attorney to solicit, accept or give anything of value in connection with any transaction or business of any financial institution |
| **18 U.S.C. 371** | Conspiracy of two or more persons to either commit a federal offense or to defraud the United States (or any agency of the U.S.). |
| **18 U.S.C. 657** | Theft, embezzlement or misapplication of credit union funds, willfully, by an officer, director, agent or employee of a credit union with intent to injure or defraud the credit union. Can infer intent to injure from the fact of injury or from acts knowingly done in reckless disregard for the interests of the credit union. |
| **18 U.S.C. 1001** | General false statements statute - knowingly and willfully falsifying or concealing a material fact or making a false statement or making or using false writing knowing it to be false. |
| **18 U.S.C. 1006** | False entries and reports or statements, including material omissions, with intent to injure or defraud the credit union, the National Credit Union Administration, NCUA examiners or other individuals or companies. |
| **18 U.S.C. 1014** | False statement (oral or written) e.g., loan application, made knowingly for the purpose of influencing any credit union whose deposits are insured by NCUA, upon any application, purchase agreement, commitment, loan (or any change or extension of same) including willfully overvaluing land, property or security. |
| **18 U.S.C. 1029** | Credit Card Fraud; knowingly and with intent to defraud, produce, use or traffic in counterfeit access devices. |
| **18 U.S.C. 1030** | Computer Fraud; knowingly accessing a computer without authorization, or using it for unauthorized purposes, including obtaining information contained in records of financial institutions. |
| **18 U.S.C. 1341** | Mail Fraud-scheme or artifice to defraud that make use of the Postal Service. |
| **18 U.S.C. 1343** | Wire Fraud-scheme or artifice to defraud using transmission by wire, radio or television for the purpose of carrying out the scheme. |
| **18 U.S.C. 1344** | Bank Fraud; scheme or artifice to defraud a federally insured institution or take money funds, credits, assets, securities or other property by misrepresentation. |
| **18 U.S.C. 1621** | Perjury/false statement made under oath (if false statement is made under oath, individual may still be prosecuted under 18 U.S.C. 1001 or 1014). |
| **18 U.S.C. 1951**<br>**18 U.S.C. 1961, et seq.** | Racketeer Influenced and Corrupt Organization ("RICO") statutes. Investing in any enterprise affecting commerce if the funds for the investment are derived from "a pattern of racketeering activity" (these activities are defined to include: murder, drug dealing, bribery, robbery, extortion, counterfeiting, mail fraud, wire fraud, embezzlement from pension funds, obstsruction of criminal investigations, fraud in the sale of securities, etc.) |
| **18 U.S.C. 2113** | Bank robbery and incidental crimes; including taking of any property in excess of $100 in value belonging to a bank, savings and loan or credit union, and receiving, possessing or disposing of same. |
| **31 U.S.C. 5311**<br>**31 C.F.R. 103** | Currency Transactions/Bank Secrecy Act. |

## NCUA REGIONAL OFFICES

**Region I (Boston)**
Regional Director
441 Stuart Street, 6th Floor
Boston, MA 02116
(617) 223-6807

**Region II (Capital)**
Regional Director
1776 G Street, N.W., Suite 700
Washington, D.C. 20006
(202) 682-1900

**Region III (Atlanta)**
Regional Director
1365 Peachtree Street, N.E., Suite 540
Atlanta, GA 30367
(404) 881-3127

**Region IV (Chicago)**
Regional Director
230 South Dearborn, Suite 3346
Chicago, IL 60604
(312) 886-9697

**Region V (Austin)**
Regional Director
611 East 6th Street, Suite 407
Austin, TX 78701
(512) 482-5131

**(Region VI (Walnut Creek)**
Regional Director
2890 North Main Street, Suite 101
Walnut Creek, CA 94596
(415) 556-6277

# INSTRUCTIONS

**Introduction:** The purpose of this form is to provide a consistent means by which credit unions can make referrals of known or suspected criminal activity perpetrated against the credit unions whether by insiders or those outside the credit union. The form will provide an effective means by which appropriate law enforcement and supervisory authorities will be made aware of known or suspected criminal activity. Credit unions should use care in filling out this form and should ensure that it is filled out in as completed a manner as practicable under the circumstances.

THE FOLLOWING INSTRUCTIONS SHOULD BE REFERRED TO WHEN FILLING OUT THE ITEMS REFERENCED:

**Item 1.** Federal credit unions use charter number. State-chartered credit unions use insurance certificate number.

**Item 2.** As of end of most recent calendar quarter.

**Item 3.** Self-explanatory.

**Item 4.** Enter a check mark next to those descriptions in 4(a) which most generally describe the nature of the criminal activity. Use the list of criminal statutes provided on page 6 as an aid to filling out item 4(b).

**Item 5.** Self-explanatory.

**Item 6.** Complete subparagraphs (a) through (g) on each individual suspected of criminal activity. This list should include primary suspects only. Individuals who may have knowledge of the suspected criminal activity, but who are not themselves suspected of being involved, should be listed as witnesses under Item 14. Provide any additional details known with respect to prior referrals or affiliations.

**Item 7.** Provide a brief narrative description of the activity giving rise to the referral. For those filing the long version of this form, details will be provided later in the form. The purpose of this paragraph is to provide a summary description of the overall transaction.

**Item 8 through 10.** Self-explanatory.

**Item 11.** This section of the referral is critical. It should be as detailed as circumstances permit. The care with which this section is written may make the difference in whether or not the described conduct and its criminal nature are clearly understood. The discussion points listed in this section are not exhaustive. They should be covered, but to the extent an additional category should be addressed, it should be done here. Feel free to use attachments or to continue the description on a separate sheet. Include any suggestons for the interviewing of any witnesses, gathering of any documents or methods of investigation which might prove useful in following up on the referral (.e.g., tracing of proceeds).

**Items 12 through 16.** Self-explanatory.

ADDITIONAL INSTRUCTIONS FOR EXAMINERS

Examiners should fill out this form whenever suspected criminal activity has been identified in a credit union and either has not yet been reported by the credit union or the referral made by the credit union is deemed to be inadequate. It is important to note that the form should be filled out whenever criminal activity is suspected; examiners are not required to make any initial finding that such referrals would, if pursued, result in a criminal conviction. That judgment will be made by responsible law enforcement authorities.

Any questions regarding whether or not any particular activity would constitute a crime for purposes of making a criminal referral should be resolved through communications with regional office.

The purpose of this referral is to provide appropriate law enforcement authorities with complete and accurate information relating to suspected criminal activity. All information requested within the body of the form should be supplied at the time of the referral unless such information is not known or can only be supplied at a later date by operation of the Right to Financial Privacy Act. In filling out this form, examiners should avoid overly technical descriptons of transactions which might not be readily understood by law enforcement authorities unfamiliar with credit union operations.

DISTRIBUTION: If made by Credit Union.

1. Retain one copy in the credit union files.
2. Send one copy to the NCUA regional office for your credit union.
3. Send one copy to the nearest office of the FBI.
4. Send one copy to the nearest office of the U.S. Attorney.
5. Send one copy to the nearest office of the Secret Service if credit card or ATM fraud is involved.

DISTRIBUTION: If made by Examiners.

1. Retain one copy in the credit union field file.
2. Send four copies to the NCUA Regional Office.
3. Send one copy to the nearest office of the Secret Service if credit card or ATM fraud is involved.

DISTRIBUTION: If made by NCUA Regional Office.

1. Retain one copy in regional office under name of the credit union.
2. Send one copy to Director, Office of Examination and Insurance, NCUA, Washington, D.C. 20456.
3. Send one copy to the nearest office of the FBI.
4. Send one copy to U.S. Attorney. If also a criminal violation of state law, consider sending the referral to the appropriate state prosecuting authority.
5. Send one copy to the nearest office of the Secret Service if credit card or ATM fraud is involved.

DISTRIBUTION: If made by State Examiners.

1. Follow the instructions of your state supervisor concerning the distribution of this form.

DISTRIBUTION: If made by State Supervisors.

1. Follow instructions 3, 4 and 5 above.

REMOVE THIS PORTION
BEFORE ASSEMBLY

## INVESTMENT TRIAL BALANCE

Charter No. ____________

Examination Date ____________

| | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | OPTIONAL | | | | | | | |
| | | AS OF EXAMINATION DATE | | | | | | AS OF EXAMINATION DATE | | | AS OF PURCHASE DATE | | | | |
| Name and Type of Investments | Identification No./ Maturity | Coupon or Interest Rate | Par/CPV Value | Book Value | CURRENT MARKET VALUE | | Gain (Loss) | | Unamortized Premium <Discount> | Yield | Par/CPV Value | Amount | Price | Premium <Discount> | COMMENTS |
| | | | | | Amount | Bid Price | | | | | | | | | |
| (A) | (B) | (C) | (D) | (E) | (F) | (G) | (H) | (I) | (J) | (K) | (L) | (M) | (N) | (O) | (P) |
| TOTALS | ▨ | ▨ | ▨ | | | ▨ | | | | | | | | | ▨ |

*See Instructions on Reverse*

## MATURITY SCHEDULE

| | <3 Months | 3 to<6 Months | 6 to <12 Months | 12 to <24 Months | Over 24 Months |
|---|---|---|---|---|---|
| U.S. Government Obligations | | | | | |
| Federal Agency Securities | | | | | |
| Common Trust Investments | | | | | |
| Shares, Deposits, and Certificates of Other CU's | | | | | |
| Other Shares, Deposits, and Certificates | | | | | |
| Loans to Other Credit Unions | | | | | |
| Corporate Credit Unions | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| TOTALS | | | | | |

## INSTRUCTIONS

1. Complete this Investment Trial Balance, or obtain a copy of the credit union's trial balance if it contains the book and market value of all investments as of the effective date of the examination.

2. Enter the appropriate information or amounts under the columnar headings according to the following instructions:

(A) Name and Type of Investments—Enter the specific name of each investment (i.e. Ginnie Mae, U.S. Treasury Bills, SBA Loan, etc.) and the type if applicable.

(B) Identification No./Maturity—Enter the identification no., such as certificate no. or pool no. Also enter the maturity date (month and year) of the investment and if applicable, the call date (month and year).

(C) Coupon or Interest Rate—Enter the stated coupon or interest rate.

(D) Par/CPV Value—Enter the face value of the investment, or in the case of a pass-through security such as a Ginnie Mae, enter the current par value (CPV) as of the date of the examination. See the Investment Section of the Guide for a discussion of CPV.

(E) Book Value—Enter the amount of the investment on the books as of the effective date of the examination.

(F) Current Market Value/Amount—Enter the value of the investment based on the current market bid.

(G) Current Market Bid/Value Price—Enter the current bid price of the investment, based on prices listed in the Wall Street Journal, other newspaper or from a local broker.

(H) Gain(Loss)—Enter the Net Gain or Net Loss for each investment (subtract column (F) from column (E) for each investment listed).

Columns (I) through (P) are optional.

(I) For examiner use.

(J) Unamortized Premium (Discount)—Enter the amount of premium or discount that has not been amortized as of the examination date.

(K) Yield—A security purchased above or below par will have a different yield than the stated coupon rate. An approximation of yield can be made by dividing investment income received on an annual basis by the cost of the investment.

(L) Par/CPV Value—Enter the face value of the investment, or in the case of a pass-through security such as a Ginnie Mae, the par value (CPV) on the date of purchase.

(M) Premium Price/Amount—Enter the dollar amount paid for the investment.

(O) Premium (Discount)—Enter the amount of premium or discount as of the date of purchase.

(P) For examiner use.

3. Complete the Maturities Schedule.

Charter No. ____________

## COMMITMENTS TO PURCHASE/SELL SECURITIES

Examination Date ______________

| Name and Type of Investment | Type of Commitment | Trade Date | Settl. Date | Par Value | COMMITMENT PRICE | | CURRENT MARKET VALUE | | Current Book Value |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | Amount | Rate | Amount | Bid | |
| (A) | (B) | (C) | (D) | (E) | (F) | (G) | (H) | (I) | (J) |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| TOTALS | ▨ | ▨ | ▨ | ▨ | | ▨ | | ▨ | |

SEE INSTRUCTIONS ON REVERSE

(Rev. 12/81) NCUA 2380

# INSTRUCTIONS

1. Complete this form for all commitments to purchase or sell securities which are outstanding as of the effective date of the examination. All transactions involving commitments to purchase securities will be entered and totaled before any transactions involving commitments to sell securities are recorded on the form. (An exception can be made when a credit union has been engaged in pair offs or short sales and matching the purchases and sales would aid the examiner's analysis.)

2. Enter the appropriate information or amounts under the columnar headings according to the following instructions:

(A) **Name and Type of Investment**—Enter the specific name of each investment (i.e., Ginnie Mae, FNMA, etc.) and the type if applicable.

(B) **Type of Commitment**—Identify the commitment as either a standby commitment (an agreement to purchase or sell an investment at the option of the seller) or a cash forward agreement (a mandatory commitment to purchase or sell an investment).

(C) **Trade Date**—Enter the date the credit union entered into the commitment.

(D) **Settlement Date**—Enter the date the credit union will conclude the purchase or sale of the investment.

(E) **Par Value**—Enter the face value or the face value range of the investment.

Example: If a credit union commits to purchase a Ginnie Mae pass-through security ranging in size from $975,000 to $1,025,000 with an 8.5 yield, the face value range is $975,000 to $1,025,000.

(F) **Commitment Price-Amount**—Enter the maximum amount based on the highest range of the face value.

(G) **Commitment Price-Rate**—Enter the agreed upon purchase or sale price (par or percentage of par) for the investment.

(H) **Current Market Value-Amount**—This column will be completed only for commitments to purchase securities. Enter the amount of the investment calculated by applying the current market bid (as of the date the workpaper is prepared) to the highest range of the face value.

(I) **Current Market Value-Bid**—This column will be completed only for commitments to purchase securities. Enter the current bid price on the investment based on prices listed in the Wall Street Journal, other newspaper or from a local broker.

(J) **Current Book Value**—This column will be completed only for commitments to sell securities. Enter the amount of the investment recorded on the credit union's books as of the effective date of the examination.

3. Total columns (F) and (H) for all commitments to purchase securities. The difference between these amounts represents a potential gain (loss) on the outstanding commitments to purchase securities. If (F) is less than (H) a gain will be incurred.

4. Total columns (F) and (J) for all commitments to sell securities. If (F) is less than (J) a loss will be incurred.

S. G.P.O. 1981-522-066/7914

# INVESTMENT INTERNAL CONTROLS

Charter No. ____________

Examination Date ____________

| | YES | NO | N/A |
|---|---|---|---|
| 1. Does the board have written investment policies? | | | |
| INCLUDING: | | | |
| a. objectives | | | |
| b. permissible types of investments | | | |
| c. diversification | | | |
| d. maturity limits | | | |
| e. list of approved brokers | | | |
| f. pre-approved list of depository banks | | | |
| 2. Does the board review and revise investment policies periodically? | | | |
| 3. Does the board receive regular investment reports showing such data as type, amount, current valuation, maturity distribution and average yield? | | | |
| 4. Does the board review all investment transactions at least monthly and are these reviews incorporated into the minutes? | | | |
| 5. If an executive or investment committee has been authorized to make investment transactions, has the committee been provided with written guidelines and is it required to report all investment transactions to the board? | | | |
| 6. Have limitations been placed on the authority of the investment officer or manager? | | | |
| 7. Are all investment transactions properly authorized by the board or committee responsible? | | | |
| 8. Are purchase confirmations compared to the actual securities or safekeeping receipts? | | | |
| 9. Are investment documents under the control of a third party safekeeping institution, a broker or a credit union appointed custodian (official or employee)? | | | |
| 10. If investments are held by a third party: | | | |
| a. Does the credit union have a "bailment for hire" agreement with the safekeeping institution? | | | |
| b. Does the credit union receive safekeeping receipts? | | | |
| c. Does the credit union receive a periodic statement of its transactions? | | | |
| d. Was the use of safekeeping institution properly authorized? | | | |
| 11. If investments are held by a broker: | | | |
| a. Does the broker physically segregate the credit unions investments from its own? | | | |
| b. Does the broker register the security in the credit union's name? | | | |
| c. Does the broker hold the security in street name? | | | |
| d. Does the credit union have a signed account agreement with the broker? | | | |
| e. Does the credit union receive a safekeeping receipt or account statement indicating securities held in safekeeping? | | | |
| f. Has the credit union evaluated the financial condition and reputation of the broker? | | | |
| g. Was the use of the broker for safekeeping properly authorized? | | | |
| 12. If investments are controlled by a credit union appointed custodian: | | | |
| a. Are the documents kept in a safe deposit box? | | | |
| b. Is the custodian prevented from having sole access to the documents? | | | |
| c. Is the custodian prevented from having access to the accounting records? | | | |
| d. Are the documents, other than bearer securities, held in the credit union's name? | | | |
| e. Are the documents periodically inspected and reconciled with the accounting records? | | | |
| f. Are securities held as collateral on loans physically separated from securities owned by the credit union? | | | |
| g. Are supporting documents for purchases and sales reviewed periodically by persons other than the custodian? | | | |
| 13. Are there no indications of conflict of interest or kickbacks from investment brokers to the credit union officials? | | | |

*SEE DISCUSSION ON REVERSE*

## DISCUSSION

1 & 2 The needs and goals of a credit union may change based on a variety of factors such as the economy, lay-offs, strikes, etc. Investment policies should reflect and keep pace with current conditions.

3 Quantitative and qualitative information is essential in order to make informed management decisions.

4,5,6 & 7 Investments often make up a substantial portion of total assets. The board should review transactions to ensure that investment policies are being implemented as approved and to ensure that the policies promote the credit union's goals and objectives.

8 Sound business practice dictates that all securities purchased be matched to the actual security document or safekeeping receipt.

9,10,11 & 12 The board should establish policies which will protect securities held in safekeeping. It should have clear, defined procedures to ensure that the credit union minimizes its exposure to risk.

13 Investments should be made on their own merit with the goals and objectives of the credit union.

## CREDIT UNION SERVICE ORGANIZATIONS

Charter No. ____________________

Examination Date ____________________

### Legal Limitations

| | YES | NO | N/A |
|---|---|---|---|
| 1. Are all investments in CUSO(s) by the credit union within the 1% limitation of Section 107(7)(I) of the FCU Act? | | | |
| 2. Are all loans to CUSO(s) by the credit union within the 1% limitation of Section 107(5)(D) of the FCU Act? | | | |
| 3. If the credit union has invested in or made loans to more than one CUSO, does the aggregate total of either the investments or loans exceed the 1% limitations? | | | |

### Structure

| | YES | NO | N/A |
|---|---|---|---|
| 1. Is the CUSO organized as a corporation? | | | |
| 2. If a corporation, has the FCU taken adequate steps to maintain the CUSO as a corporate entity separate from itself (adequate capitalization, separate management and control, etc.)? | | | |
| 3. Is the CUSO organized as a limited partnership? | | | |
| 4. Is the FCU a limited partner? | | | |
| 5. If a limited partner, has the FCU taken the necessary steps to assure itself that it is not taking part in any activities which would either jeopardize its status as a limited partner (e.g., control daily operation, management decision)? | | | |
| 6. Has the credit union obtained a legal opinion which sets forth that the CUSO is organized in a manner that will limit the credit union's potential exposure to no more than the funds invested in or lent to the CUSO? | | | |

### Customer Base

| | YES | NO | N/A |
|---|---|---|---|
| 1. Is the CUSO organized to primarily serve credit unions and/or the membership of affiliated credit unions (as defined in 701.27(c)(1)? | | | |

2. If the CUSO primarily serves credit unions, list the names of the CUs served below and the amount of funds invested in or lent to the CUSO.

| NAME | AMOUNT |
|---|---|
| | |
| | |
| | |
| | |
| | |
| | |

### Services and Activities

| | YES | NO | N/A |
|---|---|---|---|
| 1. Do the operational services and activities being provided by the CUSO comply with Section 701.27(d)(5)(i) and (ii)? | | | |
| 2. Do the financial services and activities being provided by the CUSO fall within Section 701.27(d)(5)(i) and (ii)? | | | |

3. If the CUSO is providing a service or activity not defined in Section 701.27(d)(5)(i) or (ii), has the CUSO obtained approval from the NCUA Board? If yes, list the services or activity below.

____________________________________________________________

____________________________________________________________

____________________________________________________________

____________________________________________________________

Charter No. ____________________

Examination Date ____________________

YES NO N/A

**Conflict of Interest**

1. Is there any evidence that immediate family of officials or employees, or officials or employees themselves of an affiliated Federal credit union receive any type of compensation from a CUSO either directly or indirectly, or from any person being served through the CUSO? ....... ___ / ___ / ___
2. If there is a contract between the Federal credit union and the CUSO for reimbursement for FCU employees when such employees work for the CUSO, is the reimbursement established justified and documented? ........................................................ ___ / ___ / ___

**Accounting Procedures and Access to Information**

1. Is the Federal credit union following generally accepted accounting principles (GAAP) in its involvement with credit union service organizations? .............................. ___ / ___ / ___
2. Does the federal credit union have a written agreement with the CUSO that requires the CUSO to:
   a. Follow generally accepted accounting principles and standards? .................. ___ / ___ / ___
   b. Provide financial statements (balance sheet and income/expense statement at least quarterly to the Federal credit union? ........................................................ ___ / ___ / ___
   c. Have an annual audit performed by a Certified Public Accountant? and ............. ___ / ___ / ___
   d. Provide the NCUA Board or its representatives with access to the books and records of the CUSO? ................................................................ ___ / ___ / ___
3. Is the CUSO in compliance with its written agreement with the Federal credit union? Note specifics of non-compliance ............................................... ___ / ___ / ___

________________________________________________________________________

________________________________________________________________________

**General Information**

1. If the CUSO is a corporation, in what state has it been incorporated? ................ ____________
2. If the CUSO is a limited partnership, under what state's limited partnership law is it established? ..................................................................... ____________
3. List all services being offered by the CUSO:

| | |
|---|---|
| | |
| | |
| | |
| | |
| | |
| | |

4. (a) List the officials of the CUSO and include their titles:

| NAME | TITLE |
|---|---|
| | |
| | |
| | |
| | |
| | |
| | |

   (b) Do any of these officials also serve as an official for the credit union? ............ ___ / ___ / ___
   If yes, place an asterisk by their name above.

5. Indicate below the results of operation for the CUSO for the last four accounting periods.

| PERIOD | PROFIT (LOSS) |
|---|---|
| | |
| | |
| | |
| | |
| | |
| | |

# INVESTMENT SUPPLEMENT

Charter No. ____________________

Examination Date ____________________

| | | YES | NO | N/A |
|---|---|---|---|---|
| A. | CERTIFICATES OF DEPOSIT (Part 703—Rules and Regulations) | | | |
| 1. | Were the certificates of deposit purchased by the credit union directly from the financial institution? | | | |
| 2. | Does the credit union take physical possession of the security? | | | |
| 3. | Does the credit union receive confirmation if it is a book entry security? | | | |
| 4. | Does the credit union use a broker for the purchase of CDs? | | | |
| 5. | Are proper safekeeping arrangements made if a credit union does not take possession of a security? | | | |
| B. | COMMON TRUST AND MUTUAL FUND INVESTMENTS (Pages 4-64, 65—Accounting Manual) (May 1985 Letter #79 to Credit Unions) | | | |
| 1. | Does the credit union reconcile its statements of account monthly? | | | |
| 2. | Are deferred losses properly reflected on the credit union's records for common trust investments? | | | |
| 3. | Has the legality of the mutual funds been determined? | | | |
| 4. | Is the credit union recording the investment at the Lower of Cost or Market basis at the end of each accounting period? | | | |
| C. | REVERSE REPURCHASE TRANSACTIONS (Part 703—Rules and Regulations) | | | |
| 1. | Review the most recent Reverse Repurchase Transactions (Reverse Repo.) and determine | | | |
| a. | Are funds received from a Reverse Repo. recorded in account 812, Notes Payable? | | | |
| b. | Is the interest paid on the Reverse Repo. recorded in account 340, Interest on Borrowed Funds? | | | |
| c. | If funds obtained through a Reverse Repo. are invested, do the securities collateralizing the REPO. have a maturity date no later than the settlement date of the Reverse Repo.? | | | |
| d. | Does the credit union footnote its Statement of Financial Condition to reflect the securities used as collateral and book and market value on the settlement date? | | | |
| e. | Does the board of directors or executive committee approve all Reverse Repos since this represents borrowing by the credit union? | | | |
| D. | FEDERAL FUNDS (Page 5-196—Accounting Manual, Part 703—Rules and Regulations) | | | |
| 1. | Does the credit union receive timely notification of the amount and rate for each funds transactions? | | | |
| 2. | Is notification of the transaction followed up with a debit/credit memo from the bank? | | | |
| 3. | Does the credit union receive a monthly statement from the bank showing all the activity (transfers/income/interest paid)? | | | |
| 4. | Are all transactions in Federal funds recorded in the Journal and Cash Record? | | | |
| 5. | Does the credit union reconcile the monthly statement or debit/credit memos to the credit union's Journal and Cash Record and/or General Ledger and subsidiary ledger? | | | |
| 6. | Are funds transferred by the credit union itself to the bank? | | | |
| 7. | Are all arrangements for the credit union's Federal funds program made by the credit union itself and not through a third party? | | | |
| 8. | Before entering into a Federal funds transaction with a bank, did the credit union evaluate the financial condition and reputation of the bank since this type of transaction is not insured? | | | |
| | Federal funds—(to sell) | | | |
| 1. | Does the credit union record all sales of funds in General Ledger account 746, Other Shares, Deposits and Certificates? | | | |
| 2. | Is interest earned on the funds recorded in account 121, Income from Investments? | | | |
| | Federal funds—(to buy) | | | |
| 1. | Does the credit union record all purchases of funds in general ledger account 813, Federal Funds Payable? | | | |
| 2. | Is the interest paid on the funds recorded in account 340, Interest on Borrowed Funds? | | | |

## INVESTMENT SUPPLEMENT

Charter No. ____________

Examination Date ____________

| | YES | NO | N/A |
|---|---|---|---|
| E. SMALL BUSINESS ADMINISTRATION (SBA) SECONDARY PARTICIPATION (Pages 6-77, 78, Accounting Manual) | | | |
| 1. Has the credit union properly completed and filed all required forms with SBA? | | | |
| 2. Does the credit union have procedures in place to notify the lender if the borrower is in default for 60 days or more? | | | |
| 3. Does the credit union have in place procedures for filing a claim after demand is made on the lender regarding a default? | | | |
| F. CASH FORWARD AGREEMENTS (To purchase) (Page 6-72—Accounting Manual, Part 703—Rules and Regulations) | | | |
| 1. Does the credit union maintain a current register which includes the following information on the type of security purchased, complete description, trade and settlement dates, amount, coupon rate, purchase price and name of seller? | | | |
| 2. Was the settlement date less than 120 days from the trade date? | | | |
| 3. Did the credit union prepare a written cash flow projection evidencing its ability to purchase the underlying security on the settlement date? | | | |
| 4. Were the cash flow projections made prior to the credit union making the committment to purchase? | | | |
| 5. Was the cash forward agreement settled on a cash basis at settlement date? | | | |
| 6. Was the underlying security recorded in the General Ledger at lower of cost or market when purchased? | | | |
| 7. If the security was purchased at a loss, was the loss recorded in account 420, Gain (loss) on Investments when purchased? | | | |
| G. CASH FORWARD AGREEMENTS (To Sell (Page 6-72—Accounting Manual, Part 703—Rules and Regulations) | | | |
| 1. Does the credit union maintain a current register which includes the following information; type of security sold, trade and settlement dates, price sold for and name of purchaser? | | | |
| 2. Does the credit union footnote its Statement of Financial Condition for the period the committment is outstanding? | | | |
| 3. Did the credit union record the gain or loss on the sale of the security at the time of settlement? | | | |
| H. REPURCHASE TRANSACTIONS (Investment Type) (Page 6-73—Accounting Manual, Part 703 Rules and Regulations) | | | |
| 1. Does the credit union maintain a current register which contains the following information; identification of the security (type, face value, coupon rate) and trade and settlement dates? | | | |
| 2. Can the credit union prove clear evidence of ownership for those securities that it has in its physical possession? | | | |
| 3. Does the credit union have a bailment for hire contract and a safekeeping receipt if the security is held by a third party or other financial institution? | | | |
| 4. Are the securities that are purchased recorded at cost in the appropriate investment account? | | | |
| 5. Is the credit union footnoting its Statement of Financial Condition to reflect the dollar amount of securities which are subject to resale and the date of resale? | | | |
| 6. Is income earned on the purchased securities being recorded in account 121, Income from Investments? | | | |
| I. REPURCHASE TRANSACTIONS (Loan Type) (Page 6-73—Accounting Manual, Part 703—Rules and Regulations) | | | |
| 1. If the repurchase transaction is with a member, did the credit union: | | | |
| a. Make the loan in accordance with and within the limitations established in the FCU Act and Bylaws & NCUA Rules & Regulations? | | | |
| b. Have it approved by the credit committee? | | | |
| c. Execute a note which is supported by documentation of collateral? | | | |
| d. Record the loan in account 718, Loans Subject to Repurchase Transaction? | | | |

## INVESTMENT SUPPLEMENT

Charter No. ____________

Examination Date ____________

| | | YES | NO | N/A |
|---|---|---|---|---|
| 2. | Does the credit union footnote its Statement of Financial Condition to reflect the market value for each month the repurchase transaction is outstanding? | | | |
| 3. | Is income received from the repurchase transaction properly recorded in the appropriate General Ledger Account (account 111, Interest on Loans to Members or account 121, Income from Investments? | | | |

---

J. REPURCHASE TRANSACTION (Financial Institution Type) (Part 703—Rules and Regulations)

| | | YES | NO | N/A |
|---|---|---|---|---|
| 1. | Is the repurchase transaction with a Section 107(8) of the FCU Act type institution? | | | |
| 2. | Does the credit union receive a confirmation indicating the securities are segregated on their behalf as a condition of the transaction? | | | |
| 3. | Since the credit union does not have control over the securities, has it analyzed the creditworthiness of the institution and determined that it has the ability to repay? | | | |
| 4. | Are the securities that are purchased recorded at cost in the appropriate investment account? | | | |
| 5. | Is the credit union footnoting its Statement of Financial Condition to reflect the dollar amount of securities which are subject to resale and the date of resale? | | | |
| 6. | Is income earned on the purchased securities being recorded in account 121, Income from Investments? | | | |

## CASH INTERNAL CONTROLS

Charter No. ____________________
Examination Date ____________________

| | Yes | No | N/A |
|---|---|---|---|
| **BANK RECONCILEMENTS** | | | |
| 1. Are checks that have been outstanding for a substantial period transferred to Accounts Payable (The Accounting Manual for FCUs suggests transfer to Accounts Payable after the check has been outstanding for 90 days)? | | | |
| 2. Is a procedure in place to follow up on checks of a material size that have been outstanding for a substantial period? | | | |
| 3. Are adjusting entries to the bank reconcilement cleared in a timely manner (should not exceed 60 days)? | | | |
| 4. Are deposits made in accordance with Article XV, section 1 of the FCU Bylaws? (See Reverse) | | | |
| *5. Is the bank reconcilement prepared by someone who is not involved in other cash functions? | | | |
| 6. Do the internal/external auditors periodically prepare the bank reconcilements on a surprise basis? | | | |
| 7. Has the credit union established a procedure to insure that the bank reconcilement will be completed promptly each month? | | | |
| **CHANGE FUND** | | | |
| 1. Is the daily change fund activity properly recorded and identified in the Journal & Cash Record? | | | |
| 2. Are checks to replenish the change fund made payable to the credit union only? If the change fund is replenished by a direct cash shipment from the bank, does the credit union promptly receive a debit slip from the bank? | | | |
| 3. Are currency shipments received and counted under dual control? | | | |
| 4. Has the board of directors established an amount for the change fund? Amount Approved: Permanent__________Temporary__________ | | | |
| 5. Is management made aware of all adjustments to the change fund? | | | |
| 6. Are adjustments of a substantial size approved by the board of directors? | | | |
| 7. If the credit union maintains branch offices, has the credit union instituted procedures to assure accountability to the main office for change fund activity? | | | |
| 8. Is there an adequate ATM cash loading procedure? | | | |
| **TELLER OPERATIONS** | | | |
| 1. Do all tellers have sole access to their own cash supply and are all spare keys kept under dual control? | | | |
| 2. Do all tellers have their own controlled cash drawer in the safe or vault to store their cash supply during non-working hours? | | | |
| 3. Is each teller's cash verified periodically on a surprise basis by the head teller or internal/external auditors? | | | |
| 4. Are cash drawers provided with locking devices to protect the cash during periods of teller absence? | | | |
| 5. Is an individual cumulative over and short record maintained for all persons handling cash? | | | |
| 6. Are material teller differences required to be reported to management for clearance? | | | |
| 7. Are teller transactions identified? | | | |
| 8. Are maximum amounts established for tellers cashing checks or disbursing share withdrawals without approval? | | | |
| 9. Are tellers prohibited from processing their own checks and processing transactions on their own share and loan accounts? | | | |
| 10. Are tellers required to clear all checks from their funds daily? | | | |
| 11. Are the cash supplies assigned to the tellers kept at a reasonable minimum? | | | |
| 12. Are teller duties restricted to teller operations? | | | |
| 13. Are mail receipts opened and recorded under dual control? | | | |
| 14. Are deposits made in night depositories opened and recorded under dual control? | | | |
| **MONEY ORDERS/TRAVELERS CHECKS** | | | |
| *1. Is the reserve stock of consigned items maintained under dual control? | | | |
| 2. Are all tellers assigned their own supply of money orders and travelers checks? | | | |
| 3. Are the working supplies assigned to the tellers kept at a reasonable minimum? | | | |
| 4. Are the working supplies assigned to the tellers adequately protected during business hours? | | | |
| 5. Is the working supply secured in a vault or safe after regular business hours? | | | |
| 6. Does each teller prepare a daily settlement sheet? | | | |
| 7. If the credit union maintains branch offices, has the credit union instituted procedures to assure accountability to the main office of sales and stock? | | | |
| 8. Are remittance for sales made on a regularly scheduled basis? | | | |

* These questions may not be applicable for less complex credit unions.

"NO" Answers may indicate material weaknesses in internal controls.

Cash internal controls are: Satisfactory __________; Unsatisfactory ________.

*SEE DISCUSSION ON REVERSE*

## DISCUSSION

### Bank Reconcilements

1. Allowing checks to remain outstanding for long periods weakens the internal control over cash disbursements. Cash shortages can be concealed when checks are allowed to remain outstanding.

2. Same as #1—In addition, the procedures should require management to contact the payee to ascertain the reason for nonpresentation.

3. By requiring adjusting entries to be made in a timely manner, the credit union will prevent concealment of cash shortages. Depending upon the size of the credit union, adjustments not properly recorded could impact on the credit union's financial condition.

4. Funds must be deposited no later than the second banking day after receipt. Provided, however, that receipts in aggregate of $300 or less may be held as long as one week before they are deposited.

5. To prevent misappropriation of funds by an employee, credit unions with several employees or an accounting department should require that bank reconcilements be completed by an employee not involved in any other cash function. This method also strengthens the credit union's internal controls over cash since there is now dual control.

6. Completion of the bank reconcilement periodically by the internal/external auditor will ensure that established internal controls are followed. Periodic completion of the bank reconcilement to verify the cash in the bank also serves as a deterrent against the misappropriation of funds.

7. The reconciliation must be completed promptly because a material difference could affect the credit union's cash position. Furthermore, more than one person should be trained to complete the reconciliation should the person responsible for it be out sick or on vacation.

### Change Fund

1. All entries should be clearly identified to assure proper accounting of the change fund activity. Credit unions with a large volume of change fund activity should segregate the change fund in the Journal and Cash Record. Clearly identified entries involving the change fund will assist the credit union in reconciling the change fund to the General Ledger control account.

2. These methods provide an accurate record for verifying funds needed to replenish the change fund for any given day. This procedure also prevents misappropriation of funds.

3. Dual control should be used in order to verify the cash received should a shortage occur. It also prevents cash shortages from occurring internally.

4. Article XV, section 3 of the FCU Bylaws requires the board of directors to authorize a change fund. The amount established should be based on current or anticipated needs.

5. This procedure is necessary so that management is aware of what occurred and if necessary, to be sure corrective action has been taken to avoid reoccurrence of the situation.

6. The treasurer or management should be reporting any substantial adjustments to the board of directors so that the board is aware of the problem, that corrective action has been taken to prevent it from occurring again, and that a bond claim was filed if warranted.

7. The credit union should have in place procedures for reporting by branch offices so that the main office (accounting department) can maintain accurate accounting for change fund activity. This will substantially reduce the possibility of differences or losses occurring.

8. The credit union should have a procedure requiring dual control over the loading of its own ATM's. The audit and operating procedures should provide for periodic verification of the cash amounts contained in ATM's.

### Teller Operations

1. (a) Restricted access to a teller's drawer is necessary so that if a difference should occur there is no question as to who is responsible. (b) Dual control should be maintained over spare keys so that entry cannot be made by an employee without another employee being present.

2. Same as 1 (a) above.

3. Periodic verification by internal/external auditors is necessary to ensure that tellers and management are adhering to sound principals of internal control and to verify the cash supply assigned to each teller. Verification of the cash drawers on a periodic basis serves as a deterrent against cash shortages.

4. Same as 1(a) above.

5. A cumulative over and short record must be maintained for each teller in order to evaluate the teller's performance. If disciplinary action is taken because of numerous shortages occurring, this information would be vital.

6. This procedure is necessary so that management is aware of what occurred and if necessary, to be sure corrective action has been taken to avoid reoccurrence of the situation.

7. Identification of all transactions is necessary so that each can be traced to the responsible person.

8. Large transactions should be reviewed by the head teller to ensure that all procedures have been followed (identification received, account verification made, restrictions on the account, etc.) before the transaction has been completed. Verification by a second employee reduces the possibility of the credit union sustaining a loss through fraud or embezzlement.

9. (a) Tellers should be prohibited from processing their own checks to prevent cash shortages by manipulation of their cash supply. (b) Tellers should be prohibited from processing transactions involving their own accounts to prevent manipulation of their account records.

10. This is necessary to prevent concealment of cash shortages.

11. This is necessary to reduce the exposure of a loss occurring and to maintain better control of the cash supply.

12. This control is necessary to prevent a teller from misappropriating funds by manipulation of account records.

13. Dual control over mail receipts or as a minimum rotation of duties are important safeguards over manipulation of mail accounts.

14. Dual control over night depository items is essential due to the large amounts of cash involved, and numerous errors made by members in making deposits.

### Negotiable Items

#### Money Orders/Traveler's Checks

1. Dual control maintained over the reserve stock of consigned items is aimed at preventing shortages from occurring and strengthens the controls in accounting for the reserve.

2. Assigning each teller a supply of consigned items reduces the exposure to errors occurring in accounting for the consigned items and in the possibility of a shortage occurring. In addition, if a difference does occur there is no question as to who is responsible.

3. To reduce the exposure of a shortage occurring and to retain better accountability for the consigned items, the working supplies should be kept to a reasonable minimum.

4. These negotiable items should be treated the same as a teller's cash supply. During business hours the negotiable items should be under the sole control of the teller, in a drawer with a locking device. Restricted access is necessary so that if a difference occurs there is no question as to who is responsilbe.

5. This is nocessary to reduce the exposure of a loss occurring.

6. Each teller must prepare a settlement sheet to maintain accurate accounting for these negotiable items. It is also valuable in reviewing a teller's performance.

7. The credit union should have in place procedures for reporting by branch offices so that the main office (accounting department) can maintain accurate accounting for these negotiable items. This will substantially reduce the possibility of differences or losses occurring in the program.

8. To avoid cancellation of a contract by the vendor or the U.S. Government, the credit union must institute a procedure to remit the proceeds from the sales on a timely basis. Cancellation of a contract by the vendor for this reason implies that management and the board of directors are not meeting their responsibilities. This procedure will also reduce the possibility of the concealment of a shortage.

## FEDERAL RESERVE PAYMENT SYSTEM RISK PROGRAM

Charter No. ____________________

Examination Date ____________________

| | YES | NO | N/A |
|---|---|---|---|
| 1. Does the Federal credit union have direct access to the Fedwire? | | | |
| a. If no, unnecessary to complete checklist | | | |
| 2. Has the credit union incurred daylight overdrafts? | | | |
| 3. Has the credit union established a maximum amount of overdraft (cap)? | | | |
| 4. In establishing the cap, did the credit union adequately evaluate: | | | |
| a. Credit Union Policies & Procedures? | | | |
| b. Operational Controls, Policies & Procedures? | | | |
| c. Creditworthiness? | | | |
| 5. Is the credit union's overall assessment reasonable? | | | |

**COMMENTS:**

## CURRENCY AND FOREIGN TRANSACTIONS LETTER

Charter No. ____________________

Examination Date ____________________

TO THE TREASURER OR MANAGER OF THE FEDERAL CREDIT UNION BEING EXAMINED:

The Department of the Treasury has issued regulations to implement Public Law 91-508, the Financial Recordkeeping and Currency and Foreign Transactions Reporting Act. Those regulations name the National Credit Union Administration as the enforcing agency for Federal credit unions.

Under certain circumstances the regulations provide for civil and criminal penalties for failure to maintain the required records or to file the required reports. The penalties become more severe when the regulations are violated in furtherance of certain Federal crimes.

Answer the following questions to the best of your knowledge and belief, sign this letter, and return it to the examiner. See definitions on the reverse of this letter.

| Does the credit union: | Yes | No | N/A |
|---|---|---|---|
| 1. Report all currency transactions of more than $10,000 on Form 4789, Currency Transactions Report (103.22)? | ☐ | ☐ | ☐ |
| 2. Report all currency or monetary instrument transactions of more than $10,000 into or out of the United States on Form 4790, Report of International Transportation of Currency or Monetary Instrument (103.23)? | ☐ | ☐ | ☐ |
| 3. Record the social security or taxpayer identification number of any person whose account is affected by a reportable transaction (103.26)? | ☐ | ☐ | ☐ |
| 4. Retain records for 5 years of extensions of credit of more than $5,000 (except for real property) which contain the name and address of the borrower, the amount, the date and the nature of purpose of the extension (103.33)? | ☐ | ☐ | ☐ |
| 5. Retain a record for 5 years of any transaction into or out of the United States involving more than $10,000 (103.33)? | ☐ | ☐ | ☐ |
| 6. Secure and maintain all social security or taxpayer identification numbers for each account opened and a list of those the credit union has been unable to obtain (103.34)? | ☐ | ☐ | ☐ |
| 7. Retain for 5 years each document granting signature authority over each share account (103.34)? | ☐ | ☐ | ☐ |
| 8. Retain for 5 years each statement of account or ledger card (103.34)? | ☐ | ☐ | ☐ |
| 9. Retain for 5 years all records associated with each transaction of more than $10,000 into or out of the United States (103.34)? | ☐ | ☐ | ☐ |

____________________ Treasurer or Manager

____________________ Federal Credit Union

____________________ Signature

____________________ Date

DEFINITIONS ON REVERSE

Rev. 6/86) NCUA 2435

# DEFINITIONS

CURRENCY—The coin and currency of the United States or of any other country, which circulates in and are customarily used and accepted as money in the country in which issued. It includes U.S. silver certificates, U.S. notes and Federal Reserve notes, but does not include bank checks or other negotiable instruments not customarily accepted as money.

MONETARY INSTRUMENTS—Coin or currency of the United States or of any other country, travelers' checks, money orders, investment securities in bearer form or otherwise in such form that title thereto passes upon delivery, and negotiable instruments (except warehouse receipts or bills of lading) in bearer form or otherwise in such form that title thereto passes upon delivery. The term does not include bank checks made payable to the order of a named person which have not been endorsed or which bear restrictive endorsements.

PERSON—An individual, a corporation, a partnership, a trust or estate, a joint stock company, an association, a syndicate, joint venture, or other unincorporated organization or group, and all entities cognizable as legal personalities.

TRANSACTION IN CURRENCY—A transaction involving the physical transfer of currency from one person to another. A transaction which is a transfer of funds by means of bank check, bank draft, wire transfer, or other written order, and which does not include the physical transfer of currency is not a transaction in currency within the meaning of this definition.

UNITED STATES—The various States, the District of Columbia, the Commonwealth of Puerto Rico, and the territories and possessions of the United States.

Note: References refer to Part 103 of the Treasury Department's Regulations, Financial Recordkeeping and Reporting of Currency and Foreign Transactions.

# OPERATING FEE/SHARE INSURANCE PREMIUM/CAPITALIZATION DEPOSIT OVER/UNDER PAYMENT ADJUSTMENT REQUEST

_______________ CREDIT UNION   CHARTER/ INSURANCE CERT. NO. ______________ REGION _____

The ___ Operating Fee was incorrectly computed and paid for calendar year ________.
___ Share Insurance Premium was incorrectly computed and paid for calendar year ________.
___ Capitalization Deposit was incorrectly calculated and paid as of ________.

| Operating Fee | | | Share Insurance Premium | | |
|---|---|---|---|---|---|
| Assets Reported: | (__/__/__) | $ ________ | Shares Reported: | (__/__/__) | $ ________ |
| Correct Assets: | (__/__/__) | ________ | Correct Shares: | (__/__/__) | ________ |
| Amount Paid: | | ________ | Amount Paid: | | ________ |
| Correct Amount: | | ________ | Correct Amount: | | ________ |
| Balance Due to NCUA: | | ________ | Balance Due to NCUA: | | ________ |
| Refund Due to CU: | | ________ | Refund Due to CU: | | ________ |

**Capitalization Deposit**

| | | |
|---|---|---|
| Shares Reported: | (__/__/__) | $ ________ |
| Correct Shares: | (__/__/__) | ________ |
| Required 1% Deposit: | | ________ |
| Amount on Deposit with NCUSIF: | | ________ |
| Balance Due to NCUSIF: | | ________ |
| Refund Due to CU: | | ________ |

Reasons for over/under payment: ________________________________________

---

**NET OVERPAYMENT:** NCUA is requested to refund $ ______________ to the above named CU at the following address: ______________________________

**NET UNDERPAYMENT:** Enclosed is a check in the amount of $ ______________ from the above named CU. Mail check made payable to NCUA together with white copy of this form to:

NCUA-Controller's Office
1776 G. Street
Washington, D.C. 20456

________________ Examiner   ____________ Date

White—NCUA-Controller's Office
Yellow—Regional Office
Pink—Credit Union
Goldenrod—Examiner

NCUA 2460 (Rev. 11/85)

# NATIONAL CREDIT UNION ADMINISTRATION
# FOLLOW-UP EXAMINATION

______________________________
Federal Credit Union

Charter Number ____________________

As of ____________________

Rating (EWS Code) ____________________

______________________________
Examiner-in-Charge

A follow-up examination of your credit union was conducted by the National Credit Union Administration. The objectives of the follow-up examination were primarily directed toward addressing the status of problems identified during the previous examination. This narrative summarizes the status of previously noted areas of concern and any significant problems which may have developed subsequent to the previous examination.

If the board is not in substantial agreement with the contents of this report, a request should be made promptly to the Regional Director for a review of these matters. All correspondence should be addressed to the Regional Director, National Credit Union Administration.

## I. PROBLEMS NOTED AT OR SUBSEQUENT TO PREVIOUS EXAMINATION

1. ____________________
2. ____________________
3. ____________________
4. ____________________
5. ____________________
6. ____________________

## II. COMMENTS

# FOLLOW-UP EXAMINATION
(continuation)

Charter No. ____________________

Examination Date ____________________

---

# PROJECTIONS OF BALANCE SHEET AND INCOME AND EXPENSE ITEMS

Charter/Certificate No. ____________________

| | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Column No. | (1) MOST RECENT QUARTER END | | (2) FOLLOWING FOUR CALENDAR QUARTERS | | (3) | | (4) | | (5) | | (6) 2ND FOLLOWING YEAR | | (7) 3RD FOLLOWING YEAR | |
| **PERIOD ENDING** | | | | | | | | | | | | | | |
| **LIABILITIES AND EQUITY** (In Thousands) | **AMOUNT** | **%** | **AMOUNT** | **%** | **AMOUNT** | **%** | **AMOUNT** | **%** | **AMOUNT** | **%** | **AMOUNT** | **%** | **AMOUNT** | **%** |
| Regular Shares: | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | |
| Share Drafts | | | | | | | | | | | | | | |
| Other Regular Shares | | | | | | | | | | | | | | |
| Notice Accounts | | | | | | | | | | | | | | |
| Share Certificates: Short Term <1 Yr | | | | | | | | | | | | | | |
| Long Term >1 Yr. | | | | | | | | | | | | | | |
| Reserves | | | | | | | | | | | | | | |
| Undivided Earnings and Period-to-Date Earnings | | | | | | | | | | | | | | |
| Borrowing: Short Term <1 Year | | | | | | | | | | | | | | |
| Long Term >1 Year | | | | | | | | | | | | | | |
| Other (list): | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | |
| **TOTAL LIABILITIES & EQUITY** | | 100 | | 100 | | 100 | | 100 | | 100 | | 100 | | 100 |
| **ASSETS** (In thousands) | | | | | | | | | | | | | | |
| Demand Deposits and Cash on Hand | | | | | | | | | | | | | | |
| Investments: Short Term <1 Year | | | | | | | | | | | | | | |
| Long Term >1 Year | | | | | | | | | | | | | | |
| Line-of-Credit Loans | | | | | | | | | | | | | | |
| Term Loans: | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | |
| Real Estate Loans: Planned for sale | | | | | | | | | | | | | | |
| To be held | | | | | | | | | | | | | | |
| Other Loans Planned for Secondary Market | | | | | | | | | | | | | | |
| Allowance for Loan Losses | | | | | | | | | | | | | | |
| NCUSIF Guaranty Account | | | | | | | | | | | | | | |
| Other (list): | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | |
| **TOTAL ASSETS** | | 100 | | 100 | | 100 | | 100 | | 100 | | 100 | | 100 |

| | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | (8) MOST RECENT QUARTER END | | (9) FOLLOWING FOUR CALENDAR QUARTERS | | (10) | | (11) | | (12) | | (13) 2ND FOLLOWING YEAR | | (14) 3RD FOLLOWING YEAR | |
| **PERIOD ENDING** | | | | | | | | | | | | | | |
| **INCOME** | **AMOUNT** | **%** | **AMOUNT** | **%** | **AMOUNT** | **%** | **AMOUNT** | **%** | **AMOUNT** | **%** | **AMOUNT** | **%** | **AMOUNT** | **%** |
| Interest on Loans | | | | | | | | | | | | | | |
| Income from Investments | | | | | | | | | | | | | | |
| Other | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | |
| Total Income | | 100 | | 100 | | 100 | | 100 | | 100 | | 100 | | 100 |
| EXPENSES | | | | | | | | | | | | | | |
| Dividends | | | | | | | | | | | | | | |
| Amort. of NCUSIF Guaranty Account | | | | | | | | | | | | | | |
| Interest on Borrowed Money | | | | | | | | | | | | | | |
| Provision for Loan Losses | | | | | | | | | | | | | | |
| Other (list): | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | |
| Total Expense | | 100 | | 100 | | 100 | | 100 | | 100 | | 100 | | 100 |
| Reserve Transfer | | | | | | | | | | | | | | |
| Result of Operations | | | | | | | | | | | | | | |
| Expense Ratio | | | | | | | | | | | | | | |

## ASSUMPTIONS

Rate of Share growth:

Rate of Loan growth:

Average rate to be earned on loans:

Average rate to be earned on investments:

Rates to be paid for shares:

Rates to be paid for notes payable:

Other

See Instructions on Reverse

(Rev. 12/81) NCUA 2963

# INSTRUCTIONS

1. The specific Balance Sheet items preprinted on the workpaper are for convenience in completion. These items may be changed to meet the needs of individual cases. It is important to project Balance Sheet items that relate to the liquidity and income producing ability of the credit union. However, projections may not be accurate if excessive detail of individual items is attempted. On the other hand, it is important to provide a separation of items as to maturity, cost, or income producing ability. For this reason types of share accounts, borrowing, types of loans and investments should be detailed. The specific Income and Expense items preprinted on the workpaper are necessary for any reasonable projections and generally should not be altered. However, these items may be expanded as necessary to meet the needs of individual cases.

2. Columns (1) and (8) will be completed as of the most recent quarter end. Columns (2) through (5) and columns (9) through (12) will be used to project the next four calendar quarters, and columns (6) and (7) and (13) and (14) will be used to project the two twelve month periods that follow the quarterly projections.

EXAMPLE: If the current month end is July 31, 2001, columns (1) and (8) will show actual information as of June 30, 2001. Columns (2) through (5) will show projections of Balance Sheet items for September 30, 2001, December 31, 2001, March 31, 2002, and June 30, 2002.

Columns (9) through (12) will show projections for Income and Expense items for the same four quarters. Column (6) will show Balance Sheet projections for the period July 1, 2002 through June 30, 2003, and column (7) will project the Balance Sheet through June 30, 2004.

Likewise, columns (13) and (14) will show Income and Expense projections for the same periods. The specific time periods will be identified in the space indicated at the top of each column.

3. Projecting is not an exact science, but is an estimate of the future course of the organization. Projections are necessary to make sound decisions for the future of any financial institution.

Estimates of growth in shares and loans should be developed with credit union officials and employees. The assumed growth rates can be used to project the Balance Sheet Items, investment potential and borrowing needs can be used to project the Income and Expense items. The loan turnover rate on NCUA 2060, Key Trends and Ratios, should be completed as an aid.

The loan turnover rate is helpful to project increases in loan income based on changing interest rates on loans.

4. The percentage columns are for optional use. The columns can be used if the projections are percentages of a total instead of actual dollar amounts.

5. Any assumptions used in developing the projections will be shown as indicated.

## 19. Forms Listing for Examinations and Supervision

The following is a current list of core and optional forms. A copy of each form is included in this section in form number order.

### FORMS LIST

| NCUA Form | Title Description | Rev Date | Unit of Issue |
|---|---|---|---|
| 2010 | Examiner Contact Information | 12/85 | Set |
| 2013 | Consumer Compliance Checklist | 4/83 | Set |
| 2020 | Supervisory Exam Report (F/D) | 6/84 | Ea |
| 2030 | Examination Overview | 6/84 | Set |
| 2035 | Record of Action | 4/83 | Set |
| 2036 | Supplementary Facts | 4/83 | Set |
| 2045 | Examination Financial Data | 6/86 | Set |
| 2046 | Key Ratios | 6/86 | Set |
| 2047 | Asset Share Ratio | 6/86 | Ea |
| 2050 | Statement of Financial Condition | 5/84 | Set |
| 2051 | Statement of Income | 4/83 | Set |
| 2055 | Examination Scope | 6/86 | Ea |
| 2056 | Suggestion Form | 6/86 | Set |
| 2060 | Trends and Ratios | 6/86 | Ea |
| 2075 | Spread Analysis Worksheet | 6/86 | Ea |
| 2095 | Trial Balance | 10/82 | Ea |
| 2105 | Subsidiary Ledgers | 8/84 | Ea |
| 2110 | Collection Problem Loans | 6/86 | Set |
| 2115 | Examiner's Findings | 4/83 | Set |
| 2120 | Loan Exceptions | 4/83 | Set |
| 2130 | Management | 6/86 | Set |
| 2141 | Closed Section | 4/83 | Set |
| 2142 | Seven Column Worksheet | 5/76 | Pad |
| 2170 | Examination Information | 10/82 | Ea |
| 2210 | Allowance for Loan Losses | 6/86 | Ea |
| 2220 | Reserves and Undivided Earnings | 10/82 | Ea |
| 2230 | Board Minutes | 12/81 | Ea |
| 2238 | Corp. Central Loan Profile | 6/80 | Ea |
| 2255 | Loan Data Sheet | 6/86 | Ea |
| 2265 | Loan Internal Controls | 6/86 | Set |
| 2270 | Loan Profile | 12/81 | Ea |
| 2280 | Large/Real Estate Loan Profile | 12/81 | Ea |
| 2285 | Insiders' Loans | 6/86 | Ea |
| 2290 | Line of Credit—Credit Cards | 10/82 | Ea |
| 2296 | Commercial Loan Review Checklist | 6/86 | Ea |
| 2299 | Examination Kit | 4/83 | Kit |
| 2300 | Large Loans/Concentrations | 10/82 | Ea |
| 2310 | Collection Program | 10/82 | Set |
| 2362 | Criminal Referral Form | 2/86 | Ea |
| 2375 | Investment Trial Balance | 12/81 | Ea |
| 2380 | Commitments to Purchase/Sell Securities | 12/81 | Ea |
| 2390 | Investment Internal Controls | 6/86 | Set |
| 2391 | Credit Union Service Organization | 6/86 | Ea |
| 2395 | Investment Supplement | 6/86 | Set |
| 2425 | Cash Internal Controls | 6/86 | Set |
| 2430 | Federal Reserve Payment System Risk Program | 6/86 | Ea |
| 2435 | CFT Letter | 6/86 | Set |
| 2460 | Over/Under Payment | 11/85 | Set |
| 2610 | Follow Up Examination | 4/83 | Set |
| 2611 | Follow Up Continuation | 4/83 | Set |
| 2963 | Projections of Balance Sheet and Income/Expense Items | 12/81 | Ea |
| 2999 | Forms List | 6/86 | Ea |

(Rev. 6/86) NCUA 2999